Financial System Regulation

Commonwealth Treasury

October 2014

EY
Building a better working world

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Vicki Wilkinson
Principal Adviser
Financial System Inquiry

Private and confidential

Dear Vicki,

Cost-Benefit Analysis – Financial System Regulation.

Ernst & Young ('EY' or 'we') is pleased to present the Financial System Inquiry of the Commonwealth Treasury ('Treasury' or 'you') with this summary of qualitative conclusions of our cost-benefit analysis of Commonwealth financial system regulation ('the Report'). It represents our views on the key implications for the process by which the Commonwealth develops and implements further regulation of the Australian financial system.

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Given the complexity of the subject and the timeframe our analysis has been at a strategic level and of the nature of a rapid cost-benefit analysis. We have not independently verified, or accept any responsibility or liability for independently verifying, any information provided to us by you, nor do we make any representation as to the accuracy or completeness of the information.. To the extent that our conclusions are based on forecasts, we express no opinion on the achievability of those forecasts and thus they should not be relied upon by the Treasury.

We accept no liability for any loss or damage which may result from your reliance on any research, analyses or information so supplied. The attached report provides the outcomes of our project analysis.

If you have any queries regarding the Report, please do not hesitate to contact me on (02) 9248 4525.

Yours sincerely,

Oliver Jones
Partner, Economics, Regulation and Policy

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1. Executive summary

1.1 Our scope of work

Ernst & Young ('EY' or 'we') has been engaged by the Commonwealth Treasury ('Treasury') to evaluate the direct and indirect costs and benefits of selected sections of the larger portfolio of legislation developed to regulate Australia's financial systems. This engagement is a component of the current Financial Systems Inquiry (FSI), charged with reviewing all elements of legislation that impacts on the efficient operation of the complete system.

EY was tasked with analysing three elements of the financial regulatory system:

- 2009-2011 changes to the presentation of credit card terms and conditions to consumers
- The "Know Your Customer" provisions of the 2006 anti-money laundering legislation
- The 3 day superannuation balance transfer introduced via the "SuperStream" Government initiative.

We have undertaken each analysis separately through industry consultation and a review of publicly available information. This section of the report synthesizes the key (qualitative) findings of the consultation process. Refer to the attached appendices for further analysis pertaining specifically to each of the three regulatory elements analysed.

1.2 Industry consultation

As part of the process of collecting cost and benefit data, EY consulted with a wide range of participants in the wholesale and retail financial system.[1]

In our view, the key message from our consultation is that the Commonwealth could improve the medium term outcomes of regulatory intervention through incremental changes in how it designs and implements additional measures and how it monitors the impact (including unintended effects) of regulation that has been implemented. This was evident from the consistency of messages with regards to the process followed by the Commonwealth in implementing each of the regulatory packages under analysis. The issues raised highlighted elements of the regulatory process that, in our experience, contribute to sub-optimal outcomes for complex Government intervention structures. These are summarised below in Section 1.2.1.

We have therefore included recommendations for a potential regulatory design and implementation process that addresses the key issues that arose during the consultation process and which is consistent with EY's experience in the outcomes of the development of complex Government intervention structures.

EY is well aware of the need to adopt a balanced viewpoint in considering market responses during consultation processes in respect of government initiatives at any level, with responses frequently (and understandably) supporting the commercial aims of individual market segments. This was taken into consideration during the reporting process.

1.2.1 Summary of the key process issues

The elements that arose most consistently during the consultation process and in our view are likely to have a significant impact on the overall efficiency of the regulatory process can be summarised as:

- Limited Commonwealth appreciation of the current state of the range of market practices and sophistication

[1] Refer to the relevant Appendix for a summary of key messages relevant to the individual legislative provisions.

- Limited coordination between the government agency tasked with designing and implementing the legislation and the entity that will be the primary compliance regulator
- Industry consultation processes that did not cover key data and transaction processing functions
- Implementation timetables subject to frequent revisions, both in respect of announced measures and additional "bolt-on" provisions added during consultation processes

We have included more detailed summaries of the issues raised in the individual regulation analyses.

The table set out in the next section describes in detail a potential regulatory process that addresses these key issues, based on EY's experience in complex Government regulatory processes.

1.2.2 Implications for application of cost-benefit techniques

Our summary view is that the definition of "benefit" in a purist economic cost-benefit analysis is problematic in applying this type of analysis to the impact of regulatory intervention. Government intervention can be driven by a combination of announced policy, reaction to current events and emerging global requirements. While the long term aims of intervention are typically to improve the efficiency and transparency of the financial system, there can be short term negative effects that would distort initial cost-benefit analysis results. Our experiences in applying cost-benefit techniques to the legislative initiatives in this engagement have also highlighted the difficulties in isolating the incremental economic benefits of ring-fenced sections of the regulatory framework.

This also applies to estimating indirect economic costs since the interaction impacts of new regulation are difficult to predict and study in isolation of the general economic environment. The opposite effect is observed with the direct cost impacts of regulation. Market participants can generally readily identify the additional cost of adjusting systems to comply with new regulation and externally imposed costs (e.g. the total expense involved in AUSTRAC operations).

As a result, we believe that a more appropriate technique, particularly when time is short, to assess the medium term impact of financial system regulation is a cost effectiveness analysis. This type of analysis involves the following steps:

1. The upfront development of projections of the expected impact of the legislation
2. Early consultation with the market on the likely costs that would be involved
3. Measuring the actual impacts and costs, with review points triggered when the impact to cost measures indicate materially lower effects or materially higher costs.

Consistent application of this approach across the financial system would generate a medium term picture of the relative effectiveness of regulatory initiatives and highlight particular sections where the effectiveness has been low. This potentially allows the Commonwealth to recognise and avoid the common elements in regulatory design which are associated with poor outcomes.

1.3 Limitations of this Report

This Report is subject to the following limitations:

- We have relied on representations made to us by key stakeholders in the financial sector during the course of interviews and meetings. These representations have not been independently verified or validated by us
- The observations that we have made and documented in this Report are, by necessity, limited and qualified to reflect a number of factors. These include the limited time available to undertake our assessment, our terms of reference, and the reliance being placed on information provided to us and information that is publicly available; we have not been asked to nor have we sought to verify the accuracy of information presented in these sources

- We did not undertake any analysis to determine the appropriateness or correctness of the inputs and assumptions into this analysis
- We offer no view on the overall appropriateness or effectiveness of the regulation analysed in this report.

2. Potential Regulatory Process

2.1 Introduction

Firstly, we note that there was very broad agreement that the Government policy settings that had led to more active market intervention in the initiatives under review were appropriate and that the key factors seeking to be addressed in further regulation were those that would contribute to a more efficient financial market. Discussion identified three key market elements that the Government was addressing in its consideration of regulatory intervention:

- Correcting information asymmetries that impeded market participants making efficient decisions
- Protecting the reputation and global competitiveness of the Australian financial system
- Encouraging consistent, efficient financial transaction processing protocols.

Participants noted that all these areas should be monitored and adjusted as part of effective and proactive Commonwealth management of the financial system.

2.2 Regulatory Development Map

Table 1 below sets out a potential regulatory development process based around the application of cost effectiveness analysis. This Regulatory Development Map sets out recommended tasks by phase as well as key messages from our market consultation that are relevant to each phase. The key tasks are based upon our experience in policy development and project/change management and are intended as an indicative guide only. We recommend that further detailed analysis be undertaken, should the government with to pursue further regulation.

Table 1 Regulatory Development Map

Regulatory Process Phase	Suggested Key Phase Tasks	Participant Issues addressed via Phase Tasks
Strategic Intervention Assessment	Review of global precedents and experience in implementing similar regulation to that under study. Clear statement to the market over the strategic rationale driving the consideration of additional regulatory intervention. Early consultation phase to test the market views on medium term commercial development and the potential big picture interactions with potential Commonwealth intervention.	• "Legislation by announcement" was noted as a common problem that creates market confusion and risks • Early consultation allows the market to align medium term strategy with the Commonwealth's intervention strategy and minimise private sector expenditure that will be superseded by regulatory change
Initial Regulatory Design	Analysis of the current market operations to define in detail: • Market practices that government wishes to alter • The roles of all participants in the operations under review and the financial implications of the current transaction processes. Detailed description of the changes that the Government wishes to introduce in the market. This should clearly set out how the Government expects the roles and obligations of the current participants to change in response to further regulation.	• Effective regulation requires that the provisions are targeting the market participants that have effective control over operational processes to be adjusted. This is problematic without a detailed understanding of how transactions progress through the system and which entities are responsible for data and funding at all stages. • The development of the targets of additional regulation should have an

Regulatory Process Phase	Suggested Key Phase Tasks	Participant Issues addressed via Phase Tasks
	Where these changes create additional data/funding exchange standards the Government should consider whether it should provide an initial "clearing house" function while the market adjusts to the new standards. This prevents the possible development of monopoly structures in the early implementation processes. Consideration of the form of intervention required to implement the required market changes. This should focus on selecting strategies that will produce the minimum overall cost impacts. This should include assessment of the potential for: • Pricing controls • Additional information requirements on transaction parties • Direct transaction process requirements • Subsidy elements to encourage change in less sophisticated entities. Consideration of the compliance and reporting implications of the potential changes including: • To which parties should the potential compliance obligations and penalties apply? • What are types of sanctions appropriate to the proposed intervention? Development of clear measures of the impact of the proposed intervention both in terms of: • The intended regulatory effect; and • The imposed costs and market structure changes. This should include "user-friendly" conduits by which market participants can report costs and unintended impacts. This phase ends with development of a comprehensive map of aims of the Commonwealth in relation to the key market practices that it believes will be materially impacted by the changes as well detail on what impacts the Commonwealth expects the changes to have. This document will provide the market with an enhanced understanding of the rationale for the changes and a clear view of how the Commonwealth expects the market to process and respond to the changes.	element of risk assessment. Frequently regulators focus on the larger volume sectors of the market, where processes tend to be more sophisticated and individual process risks are lowest. Examples were given where the lest compliant and most problematic sectors were those where the Government imposed the lightest regulatory burden. • Failure to test the extent of the additional processing/information requirements risks creating unforeseen monopoly niches where the effected parties find themselves lacking particular IT capabilities. This is especially a risk where government proposes to establish new data/funding exchange standards.
Design Consultation Phase	Comprehensive industry consultation on four separate levels: 1. Executive level to ensure that there is strategic buy-in to	• Consultation that is focused at the CEO/COO level potentially misses important viewpoints on the more

Regulatory Process Phase	Suggested Key Phase Tasks	Participant Issues addressed via Phase Tasks
	the overall regulatory aims and to provide a high-level conduit for comments around how the proposed regulation might impact planned future market based developments 2. Operational level that connects the key units that handle the processing of transactions impacted by the proposed changes with the Commonwealth teams tasked with translating the operational requirements into legislative provisions 3. Financial level to assess the potential of the regulation to disturb the current financial incentives and create unexpected winners and losers in developing any required systems and interfaces 4. Compliance level to ensure that the regulatory sponsor, proposed compliance/reporting entity and the market have a common understanding of how the regulation is intended to operate and the role of the regulator in applying the legislation to optimal effect. This phase produces an update of the regulatory design that integrates the various market views into the key elements of the regulatory changes and highlights to the drafting process: • Potential "lines in the sand" around the breadth of the obligations that should be imposed on various market parties • The processing flows, both financial and informational that the proposed intervention cuts across • Key market contacts available to discuss any difficult or obscure legislation issues as they arise.	practical impacts of legislation and therefore does not provide sufficient feedback on how the Commonwealth is seeking is seeking the effect changes. • Scenarios where legislation sponsors and the proposed regulator entity have materially different viewpoints on the scope of compliance structures have produced conflicting messages after implementation – creating early agreement between all parties is a key mitigation of this risk.
Drafting Process	Detailed drafting of the legislation/regulations is a complex process and requires constant calibration against the overarching strategic intervention aims. The process should involve: • Market sector participants (potentially seconded from industry organisations)to guide the drafting process so that the terminology is consistent with market practice and to provide real-time commentary on crucial regulation structure • Establishing realistic timetables around the completion of drafting and avoid rushed delivery of complex legislation • Staged further consultation with completed drafts. This would be a tightly controlled process that allows both industry and regulator visibility over the active provisions in the legislation. The aim of the drafting process is to produce legislation that all affected parties support as effective at implementing the	• Early drafts of legislation are often written without reference to market terminology norms and from pure legal viewpoints. This slows down consultation and effective market responses as affected parties develop an understanding of the requirements of the core provisions. • An accelerated drafting process can result in legislation with significant logical and legal flaws (the GST legislation provided a number of these issues - the infinite Stamp Duty/GST being a fairly material example). • Without close industry participation the tension between risk and rule based regulation tends to be resolved in favour of more black letter regulation.

Regulatory Process Phase	Suggested Key Phase Tasks	Participant Issues addressed via Phase Tasks
	proposed regulatory changes while minimising the cost and process impacts on the market. The earlier involvement of the market in the design process will assist in creating broad understanding and acceptance of the Government regulatory aims and hence discussion at the drafting stage is confined to how the changes are documented without the need to re-visit the rationale for the changes.	Involvement of experienced industry participants in drafting may allow more effective output based provisions to be developed.
Implementation	The key to an efficient implementation process is in the development of a detailed process plan that is circulated to the market well in advance of the implementation timetable. This should be developed in parallel with the production of the final legislation drafts and in concert with industry representatives seconded to the drafting process. Important elements of the plan include: • Setting hard deadlines for the introduction and compliance restrictions of the new regulations to provide certainty to the market of when systems must be in place and thus certainty over the time available to complete upgrades. • Industry workshops clarifying the expected impact of the final regulation implemented and providing clear examples of how the industry would identify and process exceptions and the scope and format of the reporting required. • Where the regulation is comparatively complex a dedicated team within the regulator should be created to assist with industry issues and enquiries during a defined "burning in" period. No penalties should accrue during this period.	• Effected parties will base the development of system and process responses on the implementation dates announced. Frequent changes introduce additional risks to the scope and effectiveness of the changes.
Monitoring	Where the intervention is especially wide-ranging or complex the Commonwealth should develop an impact monitoring process that reports on the measures developed in the design phase and informs the Commonwealth: • Whether the intervention is producing the desired changes in market operations/behaviour • Whether there are significant second order impacts not predicted in the original design process that are have significant negative impacts on market participants. An effective assessment process would involve setting threshold impact measures that defined the minimum changes and average industry costs expected and allow for a more extensive review if the impact to cost ratio is significantly below the projected level.	• An objective analytical process by which market participants can clearly see the Commonwealth assessing and responding will generate market confidence in the overall legislative process. • Where there is no effective assessment of the impact of new regulatory intervention there is a risk that Governments will simply generate further layers of regulation rather than deal with the core issues of the newly implemented provisions.

Appendix 1

2009-2011 changes to credit card contract regulation

Commonwealth Treasury

October 2014

1. Executive Summary

1.1 Our scope of work

Ernst & Young ('EY' or 'we') has been engaged by the Commonwealth Department of the Treasury ('Treasury') to evaluate the direct and indirect costs and benefits of selected sections of the larger portfolio of legislation developed to regulate Australia's financial systems. This engagement is a component of the current Financial Systems Inquiry (FSI), charged with reviewing all elements of legislation that impacts on the efficient operation of the complete system.

1.2 Focus of this analysis: credit card contract regulation

In 2008, the Council of Australian Governments (COAG) agreed to a two-phase plan to transfer the regulation of credit providers from the State Governments to the Commonwealth Government. Phase one saw the establishment of the National Consumer Credit Protection Act 2009 (NCCP Act), and the National Consumer Credit Protection Regulations 2010 (Regulations) creating a statutory framework for the regulation of credit lenders and brokers.

In 2011, Phase two of the plan introduced further changes to the way in which credit providers are regulated through the enactment of the National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Act 2011[2]. Phase two included new obligations for credit card providers that:

- Limit the circumstances in which they can send unsolicited invitations to borrowers inviting them to increase their credit card limit
- Restrict the use of a credit card beyond the stipulated credit limit and prohibiting credit providers from charging a fee when the card is used beyond its limit
- Require lenders to direct repayments to the most expensive part of the borrower's credit card debt first
- Require lenders to calculate interest in accordance with statutory requirements
- Require lenders to inform their customers of the implications of only making the minimum repayment on their credit card debt
- Introduce the requirement for credit lenders to provide a Key Facts Sheet for credit card contracts

The additional regulatory requirements in respect of the Key Facts Sheet placed on providers of credit cards through the 2011 amendment of the NCCP Act are the subject of this analysis.

1.3 Costs of the regulation

Total costs for credit card providers associated with implementation of the systems need to comply with the phase II reforms are estimated to have been between $40m and $120m using the limited available benchmark data and assuming that there are around 40 entities issuing credit cards. There were no material ongoing management or compliance costs identified in respect of the fact sheet requirements.

A review of publicly available information did not identify any specific increase in government spending with regards to its role in management, regulation and compliance of the reforms. Ongoing costs to government are therefore considered to be immaterial for the purposes of this report.

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[2] Bill passed by Parliament on 4 July 2011,http://banking.treasury.gov.au/content/legislation_regulation.asp

1.4 Potential benefits of the Provisions

The general aim of regulation that provides consumers with additional information on the implications of the choices they make in accessing finance is to provide them with the tools to make better informed decisions. The Credit Card Fact Sheet highlighted the continuing cost to consumers of using credit cards as long term finance facilities with the potential outcome that consumers would develop strategies to minimise this cost. We analysed available data on consumer use of financing options to test whether there was any appreciable change in their behaviour:

- Proportion of credit card balances attracting interest: A possible outcome would be for consumers to more actively manage their credit card debt to minimise interest payments. Australian credit cards typically have options that provide an interest free period so in a scenario where consumers have assimilated the cost of long term credit card finance it could be expected that the proportion of card balances attracting interest would show a sustained decline.

  Our analysis of credit card balances indicates an estimated $120m in cost savings associated with avoided interest costs in the 12 months following the implementation of the Reforms.

- Decline in gross credit card balances: Where consumers come to the view that the cost of credit card interest is not sustainable we would expect them to divert a greater proportion of available cash flow to reducing this form of debt. This would be reflected in a gradual decline in outstanding credit card debt.

  A review of credit card balances reveals that they have plateaued in recent years with no appreciable trend identified with respect to the Reforms.

- Accessing more efficient finance: Australian families with mortgages are on average 12-15 months ahead in respect of the required payments. Mortgage finance is substantially cheaper than credit card finance and thus where consumers have both mortgages and credit card debt an optimal strategy would be to redraw mortgage payments and repay the credit card debt.

  Mortgage buffers have remained relatively stable over time, including throughout the GFC. This is supported by RBA data which indicates the largest offsets are made by higher income households not experiencing financial stress.

In summary, there is some evidence of a change in consumer behaviour in the period post the implementation of the Reforms that reduced exposure to the high cost of credit card debt. While it is not possible to positively attribute these changes to the reforms, we cannot rule out that they were a contributing factor to move towards a higher effective use of the interest free period of credit card products

1.5 Summary of our analysis

Discussions with market participants indicated that they did not detect material changes in customer behaviour as a result of the availability of further information on the terms under which they incurred credit card debts.

Our analysis of publicly available information detected some changes in credit card management behaviour. This is primarily evidenced by an increased proportion of credit card balances that do not accrue interest charges (estimated cost savings of $120m associated with avoided interest expense in the 12 months following implementation of the Reforms) . We note that the reforms were implemented in a low interest rate environment post the GFC so it is possible that the changes observed were driven by a return to long term trends rather than by the impacts of the regulation.

There was, however little evidence of a more sustained impact. The absence of any strong longer term trend may indicate that the credit card information initiatives either did not effectively target those most exposed to the high cost of credit card debt. Potential reasons why this may not have had the desired sustained impact include:

- Consumers did not assimilate the information supplied - Consumers are recipients of an increasing amount of informational and promotional material from the finance sector. It is not surprising that the additional information contained in the credit card fact sheets may have been overlooked as non-essential or irrelevant.
- Consumers currently exposed to material credit card debts are those least able to change their financial habits to effectively reduce these debts. Information on the high cost of credit card finance can only be actioned if a consumer has access to alternative, more efficient finance products
- Current credit usage patterns represent ingrained consumer lifestyle and financial preferences, these are likely to be difficult to alter without sustained educational initiatives.

We note that regulation that provides accurate and unbiased information on the implications of consumer finance preferences is probably a necessary but not sufficient prerequisite for consumer to make more effective financing choices.

2. Introduction

2.1 Our scope of work

We have been engaged by Treasury to evaluate the direct and indirect costs and benefits of selected sections of the larger portfolio of legislation developed to regulate Australia's financial systems. This engagement is a component of the current Financial Systems Inquiry (FSI), charged with reviewing all elements of legislation that impacts on the efficient operation of the complete system.

2.2 Our approach

The key tasks which we undertook to complete this engagement included the following:

- A consultation process with key Australian financial market participants to derive estimates of the full cost of complying with the legislation[3]
- Where possible review and analyses of key Australian economic and financial market data sets to produce estimates of the quantifiable benefits of the legislation
- Developed a rapid cost/benefit analysis of the legislation where the quantification of costs and benefits provides sufficient confidence that the most significant factors have been identified.
- Outline and qualitatively assess other costs and benefits for which reliable quantitative estimates cannot be developed.

2.2.1 Limitations of this Report

This Report is subject to the following limitations:

- We have relied on representations made to us by key stakeholders in the financial sector during the course of interviews and meetings. These representations have not been independently verified or validated by us
- The observations that we have made and documented in this Report are, by necessity, limited and qualified to reflect a number of factors. These include the limited time available to undertake our assessment, our terms of reference, and the reliance being placed on information provided to us and information that is publicly available; we have not been asked to nor have we sought to verify the accuracy of information presented in these sources
- We did not undertake any analysis to determine the appropriateness or correctness of the inputs and assumptions into this analysis
- We offer no view on the overall appropriateness or effectiveness of the regulation analysed in this report

2.3 Structure of this Report

The remainder of this Report is set out as follows:

- Chapter 3 – Provides the context to the analysis performed
- Chapter 4 – Analyses the expected costs of the provisions
- Chapter 5 – Analyses the potential benefits of the provisions

[3] The stakeholders with whom we consulted can be found in Appendix A

3. Credit Card Regulation

Summary of comments from the consultation process

In general participants did not believe that the Credit Card Fact Sheet provisions imposed a substantial regulatory cost burden on the industry. The form of the requirements allowed the fact sheet production to be embedded in existing information generation processes and thus avoid appreciable ongoing costs.

Particular comments were made on the following elements of the process:

- The fact sheet requirements appeared to be more of an afterthought in respect of the overall 2011 reform structure. As a result participants had limited time to implement the provisions and thus the cost of system changes was relatively high.

The actual role of the fact sheet in respect of the overall reform process was not made particularly clear. It was felt that greater consultation over the differing exposure and financial understanding of consumer market segments could have produced a more effective information package.

In 2011, the Commonwealth Government introduced the new regulation in respect to the provision and offering of credit cards (collectively, 'the Reforms'). The costs and benefits associated with these regulatory requirements which credit card providers are obliged to meet is the subject of this analysis.

This chapter seeks to:

- Provide an abridged background to the implementation of reforms to the way in which the providers of credit cards are regulated
- Define the legislative framework
- Define phase two of the reform package, including its objectives, and details on the specific requirements of each of the new element of the regulation in respect to the provision of credit cards

3.1 Background

In 2008, the Coalition of Australian Governments (COAG) agreed to a two-phase implementation plan to transfer the regulation of credit providers from the State Governments to the Commonwealth Government with the primary objective of enhancing consumer protection[4].

Phase one of the reform process was implemented in 2009 with the establishment if the NCCP Act. This Act provided for a national statutory framework for the regulation of credit lenders and brokers. Credit card licensees were now, and are, legally obliged to comply with the responsible lending obligations as set out in section three (of the NCCP Act). This creates an obligation for credit providers to give consideration to a customer's objectives, requirements and capacity to service debt.

Phase two of the reform package was implemented through the establishment of the *National Consumer Credit Protection Amendment (Home Loans and Credit* Cards*) Act 2011*. The amendments included new regulatory requirements in regards to the provision of home loans and credit cards. The detail on each element of regulation in relation to the provision of credit cards is discussed further on in this chapter.

[4] http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r4560_ems_b64a3e10-3a8b-45f6-a910-4ec43461b51c/upload_pdf/353739.pdf;fileType=application%2Fpdf
Agreed to at the 3 July and 2 October 2008 meetings of COAG

3.1.1 Legislative framework

National Consumer Credit Protection Act 2009 (NCCP Act) (phase one)

- Credit licensees must comply with the responsible lending obligations set out in the NCCP Act
- Licensees must: make reasonable inquiries about the consumer's financial situation, and their requirements and objectives; take reasonable steps to verify the consumer's financial situation; and make an assessment about whether the credit contract or is 'not unsuitable' for the consumer.[5]

National Consumer Credit Protection Regulations 2010 (Regulations)

National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Act 2011 (Bill passed by Parliament on 4 July 2011)[6] (phase two)

- Amended the NCCP Act to include new regulatory requirements in regards to the provision of home loans and credit cards
- Outlined additional rules relating to credit card contracts for licensees.

3.2 Phase two reforms

Building on the NCCP Act, the National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Act 2011introduced a number of further reforms in relation to the way in which credit cards are offered and used. The Commonwealth Government stated "the changes were aimed at improving the fairness and consistency in the way fees and interest are charged, giving consumers more say over credit card products, and improving disclosures to help them to better understand credit card products"7.

The Explanatory Memorandum that accompanied the National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Bill 2011(now Act), outlined the following overarching objectives of the additional regulatory obligations placed on credit card providers:

- Enhance consumers' financial wellbeing by building their capacity to make better decisions about managing their money
- Reduce the risk of consumers being provided with credit cards limits where they may be unable to pay the total balance within a relatively short period of time
- Increase consumer capacity to select products or use their credit cards in a way that reduces the level of fees and interest they are charged
- Secure the long-term safety and sustainability of the financial system so it can continue to provide reasonably priced credit to Australian households and small businesses

Specifically, the regulations:

- Limit the circumstances in which lenders can send unsolicited invitations to borrowers inviting them to increase their credit card limit (except where the consumer has consented to receive such offers)

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[5] Chapter Three of the *National Consumer Credit Protection Act 2009*

[6] http://banking.treasury.gov.au/content/legislation_regulation.asp

[7] *2010-11 The Parliament of the Commonwealth of Australia, House of Representatives, The National Consumer Credit Card Protection Amendment (Home Loans and Credit Cards) Bill 2011, Explanatory Memorandum*

- Restrict the use of a credit card beyond the stipulated credit limit and prohibiting credit providers from charging a fee when the card is used beyond its limit (unless the borrower has agreed to a supplementary buffer)[8] (except where the consumer has specifically opted to have a higher buffer (supplementary buffer))[9]
- Require lenders to direct repayments to the most expensive part of the borrower's credit card debt first (i.e. the part of the debt that is incurring the highest interest charge),
- Requiring lenders to calculate interest in accordance with statutory requirements
- Require lenders to inform their customers of the implications of only making the minimum repayment on their credit card debt
- Introduce the requirement for credit lenders to provide a Key Facts Sheet for credit card contracts

Regulation that results in increased disclosure requirements (for instance Key Fact Sheets and information on the impact of only making minimum repayments) assumes that even though consumers may have all the required information to make a rational decision, the way in which this information is presented may result in them making an irrational and/or biased decision.

For instance, a consumer could exhibit a behavioural bias where a large quantity of complex information presented encourages them to ignore the pre contractual disclosure information. Disclosure regulation, like Key Fact Sheets, seeks to counteract potential consumer biases by forcing credit card providers to simply present key information with the intent of improving a consumer's ability to make a rational and/or unbiased financial decision.

However, it is difficult to assess whether additional disclosure is necessary and whether it will provide a clear benefit to the consumer. There is a risk that further disclosure ends up being counterproductive (for instance when it repeats information already set out other documents). That is consumers end up paying for the cost of businesses meeting their disclosure requirements but do not derive any benefit from it.

3.2.1 Prevention of unsolicited credit limit increase invitations

Section 133BE of the NCCP Act prevents credit providers from offering consumers an increase to their credit limit, unless the consumer has given permission.

The Explanatory Memorandum that accompanied the *National Consumer Credit Card Protection Amendment (Home Loans and Credit Cards) Bill 2011* (now Act) stated that the objectives of this regulation are to provide consumers with "… more control over their credit and debt levels by preventing cardholders from being sent offers to increase their credit limits without their consent" and

[8] *2010-11 The Parliament of the Commonwealth of Australia, House of Representatives, The National Consumer Credit Card Protection Amendment (Home Loans and Credit Cards) Bill 2011, Explanatory Memorandum, Chapter Three, Credit Card Contracts*

[9] A consumer can exceed their credit limit provided they are within the default buffer (that is, up to 10 per cent of their credit limit), and cannot be charged a fee or additional costs by the credit provider. A consumer can elect to allow their account to exceed their credit limit by the supplementary buffer (that is, by more than 10 per cent of their credit limit), and the credit provider can charge a fee or additional costs for providing this service (with these arrangements subject to any additional requirements imposed by the regulations).

to "to allow lenders to provide credit marketing services to those who wish to receive and can afford to repay them."[10]

Limiting the ability of lenders to make unsolicited invitations to increase credit limits assists consumers in taking on more responsibility for their own debt management as they are best placed to assess their own needs and requirements (as opposed to a lender), i.e. if they require an increase to their limit.

3.2.2 Over-limit fees

Under section 133BH of the NCCP Act, providers of credit cards are required to notify consumers of use of a credit card that is in excess of their credit limit. Furthermore, section 133BI of the NCCP Act stipulates that in the instance a credit card is used and this results in its limit being exceeded, the credit provider cannot impose fees and/or charges.

The Commonwealth Government provided the following justification for the amendment to the NCCP Act" … it provides consumers with more control over their debt. They cannot unsuspectingly obtain more debt than what had previously been approved."[11]

3.2.3 Allocation of repayments to higher interest debt first

Under section 133BQ of the NCCP Act, credit licensees must direct repayments to the most expensive part of the borrower's (consumer's) credit card debt first, that is the part of the debt that is incurring the highest interest charge.

This section of the NCCP Act minimises the amount of interest paid by consumers, allowing them to clear the most expensive part of their debt first (e.g. higher interest rates charged on cash advances). It also allows consumers to maximise lower interest rates charges on debt like balance transfers, by clearing this type of debt last.

3.2.4 Standardised interest calculations

The amendments to the NCCP Act (Section 30B Regulations about credit card contracts refers) also allowed for regulations to be made setting out a standardised method for calculating interest.

The intent of this regulation is that standardising interest calculations allows consumers to better compare interest rates charged on different credit card products, assisting them in identifying the product that is most suited to their needs (e.g. spending habits and financial circumstances).

3.2.5 Information on minimum repayments

Credit licensees (who are provide credit cards) are obliged to tell consumers how long it will take to pay off the balance of their debt if only the minimum repayment is made. Specifically they must provide consumers with the following information; the period of time to pay all the debt, and the total interest payable if only minimum repayments are made.[12]

The Explanatory Memorandum that accompanied the National Consumer Credit Card Protection Amendment (Home Loans and Credit Cards) Bill 2011 (now Act) stated that "making sure consumers are made aware of the long-term implications of making minimum repayments on their credit card statements will help them manage their finances."[13]

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[10] *2010-11 The Parliament of the Commonwealth of Australia, House of Representatives, The National Consumer Credit Card Protection Amendment (Home Loans and Credit Cards) Bill 2011, Explanatory Memorandum*

[11] *2010-11 The Parliament of the Commonwealth of Australia, House of Representatives, The National Consumer Credit Card Protection Amendment (Home Loans and Credit Cards) Bill 2011, Explanatory Memorandum*

[12] https://www.moneysmart.gov.au/borrowing-and-credit/consumer-credit-regulation

[13] *2010-11 The Parliament of the Commonwealth of Australia, House of Representatives, The National Consumer Credit Card Protection Amendment (Home Loans and Credit Cards) Bill 2011, Explanatory Memorandum*

3.2.6 Key Fact Sheets

Section 133BB, 133BC, 133BD of the NCCP Act require credit card providers are required to provide an up-to-date and standardised "Key Fact Sheet" that contains information on; minimum payments are to be made, annual percentage rates (including different rates where these apply to particular liabilities), fees, and any other item set out in the Regulations. The Act also requires that consumers are provided with or have access to a "Key Fact Sheet" prior to entering in to a contact with the respective lender.[14]

The Explanatory Memorandum that accompanied the *National Consumer Credit Card Protection Amendment (Home Loans and Credit Cards) Bill 2011* (now Act) stated that the purpose of the "Key Fact Sheet" is to:

- Provide consumers with key information in an accessible form to assist them in deciding whether to enter into a particular credit card contract with a particular credit provider
- Allow consumers to both compare different credit card products more easily
- Allow consumers to have a better understanding of how to use their credit cards more efficiently to assist them in minimizing the amount they have to pay in fees and interest, or to move to another provider who can offer them products that are more suited to their spending habits
- Build the capacity of all Australians to make better decisions about managing their money and through that, enhance their financial wellbeing
- Assist consumers by increasing their capacity to select products or use their credit cards in a way that reduces the level of fees and interest they are charged
- Reduce the risk of consumers being provided with credit cards limits where they may be unable to pay the total balance within a relatively short period of time
- Secure the long-term safety and sustainability of the financial system so it can continue to provide reasonably-priced credit to Australian households and small businesses.

3.2.7 Timing and implementation

The loan provisions commenced on 1 September 2011 and the credit card provisions commenced on 1 July 2012. The credit card provisions relating to paying down the highest interest rate debt first only apply to those accounts opened on or after 1 July 2012 whereas provisions surrounding offers to increase credit limits applies to all contracts, including those issued prior to 1 July 2012. With the exception of the aforementioned considerations, the reforms did not allow a transition period and were effective from the respective commencement dates.

The data analysis contained herein has been undertaken with respect to these commencement dates.

[14] Sections 133BB, 133BC, 133BD of the NCCP Act refers

4. Identified Costs of the Regulatory Framework

The impact of the potential costs imposed on the economy associated with the Reforms can be grouped into the following categories: tax payers, credit card providers and economy wide. Based on our consultation process and a literature review of publicly available regulatory data, the following costs, stakeholders and indicators have been identified:

Table 2: Potential costs

Cost	Stakeholder	Measurement / required data
4.1.1 Increased competition driven by consumers making improved informed choices about products	Credit card providers	Reduced revenue and/or reduced costs (if efficiencies can be made)
4.1.2 Development of adequate systems and resources to meet the regulatory requirements, for instance: Ensuring payments are allocated in the requisite way • Credit card usage is not approved above the credit limit (except in certain Circumstances) • Provision of Key Facts Sheets • Record keeping	Credit card providers	Increased costs to the credit card provider and/or increased fees to the consumer
4.1.4 Management, regulation and compliance of Commonwealth Government legislation, regulation and policies	Tax payer (ASIC, Treasury)	Budget Papers, Annual Reports

4.1.1 Increased competition

No cost impact was noted during the consultation process accruing from the measures under study. It was noted that there was substantial competition with respect to credit card terms and reward mechanisms emerging prior to the implementation of the 2011 phase two regulations.

4.1.2 Development of adequate systems and resources to meet the regulatory requirements

Direct costs for the implementation of the Credit Card Fact Sheets were estimated by respondents as being between $265k and $1million with the overall system enhancements to meet the Phase II 2011 regulatory package costing between $1-3million. When applied to the number of issuing authorities, total costs across providers are estimated to range from $40m - $120m for the overall 2011 regulatory requirements. No material ongoing costs were identified as the system implementation generally embedded the production of the fact sheet into existing customer communication processes. This estimate is based on limited available data.

4.1.3 Management, regulation and compliance

A review of the annual reports published by ASIC and APRA as well as appropriations in the Budget do not indicate a significant change in year on year operations driven by the 2011 regulatory initiative. For the purposes of this Report, any costs associated with management, regulation and compliance by the government are considered immaterial.

4.2 Summary of costs

Treasury's Budget nor APRA's or ASIC's annual reports specify allocation to credit card regulation. Furthermore, information is not publicly available on any appropriation made specifically in reference to the Reforms. The overall cost profile of the fact sheet requirements was judged to be minor by market participants and little impact noted in the regulatory costs at the government level. There was no evidence that the regulation restrictions have had a material negative impact on consumer financing choices.

5. Benefits of the Provisions

5.1 Potential Benefits

The potential benefits associated with the Reforms can be grouped into three categories: tax payers, credit card users and economy wide. Based on our consultation process as well as a literature review of publicly available regulatory data, the following potential benefits, stakeholders and indicators were reviewed:

Table 3: Potential benefits

Benefit	Stakeholder	Measurement
5.1.1 Expedited reduction in debt due to repayments being directed to the most expensive part of a consumers debt	Credit card users	Reduction in credit balances over the medium term compared to mortgage balances
5.1.2 Improved decision making through provision of personalised information to existing and new consumers[15]	Credit card users	Reduction in the proportion of credit card balances attracting interest costs Overall reduction in growth in credit card balances
5.1.3 Improved ability of consumers to adapt their behaviour to minimise costs, or move to other credit card products more suited to their spending habits[16] due to accessible information	Credit card users	Reduction in the proportion of credit card balances attracting interest costs Additional observable usage of alternative financing conduits
5.1.4 Reduction in consumers financially overcommitting to credit they cannot afford	Credit card users, economy wide	Reduction in consumers reporting financial distress

5.1.1 Expedited reduction in debt due to repayments being directed to the most expensive part of a consumers debt

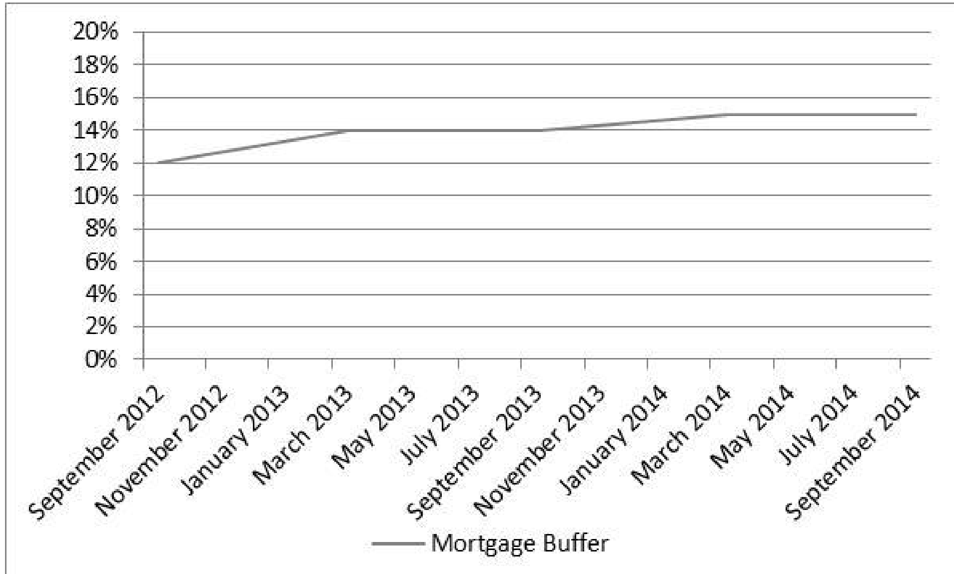
If there was a material change in the allocation of disposable income by consumers between finance obligations we would likely observe a shift between the balances outstanding on key consumer finance products. For example where consumers are in advance on their mortgage payments and have material credit card debts, a rational strategy would be to redraw against the mortgage to repay the credit card debt. We have sought to assess the extent that mortgages were redrawn by looking at the average mortgage buffer over time.[17]

[15] For example, monthly statements have to include information on how long it would take a consumer to pay off their balance if only the minimum repayments were made.

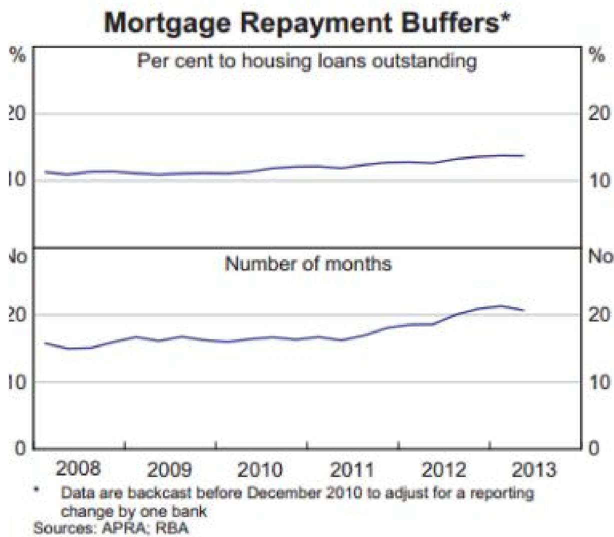
[16] For example, standardised Key Fact Sheets provides consumers with key information in an accessible form to assist them in deciding whether to enter into a particular credit card contract with the particular credit provider. It allows consumers to compare different credit card products more easily, and to have a better understanding of how to use their credit cards more efficiently, so as to minimise the amount they have to pay, in fees and interest.

[17] "Buffer" is defined as the balances in offset and redraw facilities.

Figure 1: Mortgage buffers



Source: RBA, Financial Sustainability Reviews



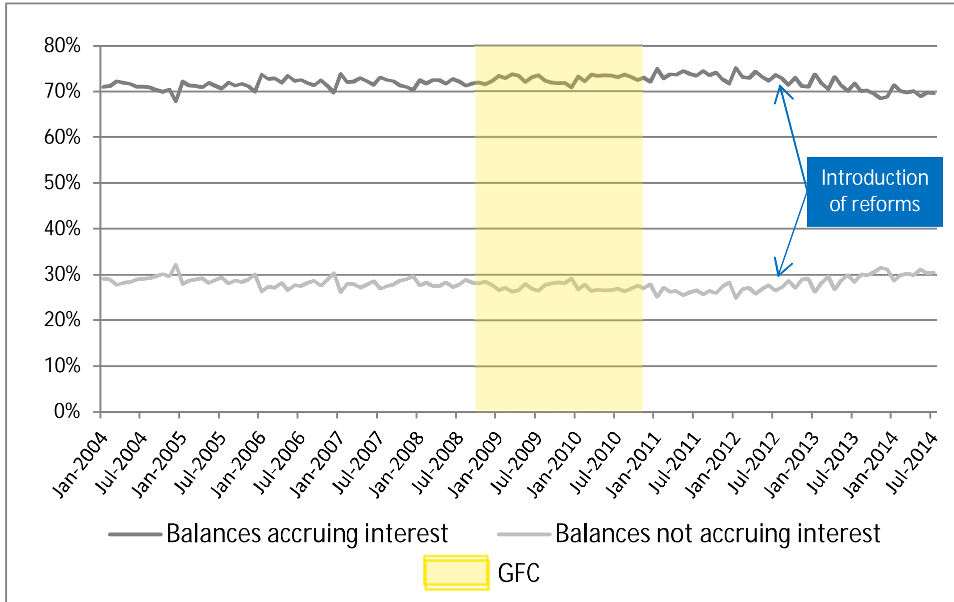
As depicted above, mortgage buffers have remained relatively stable over time, including throughout the GFC. This is supported by RBA data which indicates the largest offsets are made by higher income households not experiencing financial stress. Whilst there is a slight increase in mortgage buffers following 2010, our analysis did not detect any material trends in these measures that could be reasonably attributed to the implementation of the reforms.

5.1.2 Improved decision making

Detailed information on the longer term implications of credit choice would ideally influence consumers to assess the financial consequences of discretionary purchases more rationally. One would assume that a rational individual would seek to limit expenses associated with interest payments and fees. Successful communication of the long term costs would therefore potentially lead to more rapid repayment of credit card obligations and/or lower growth in credit card debt.

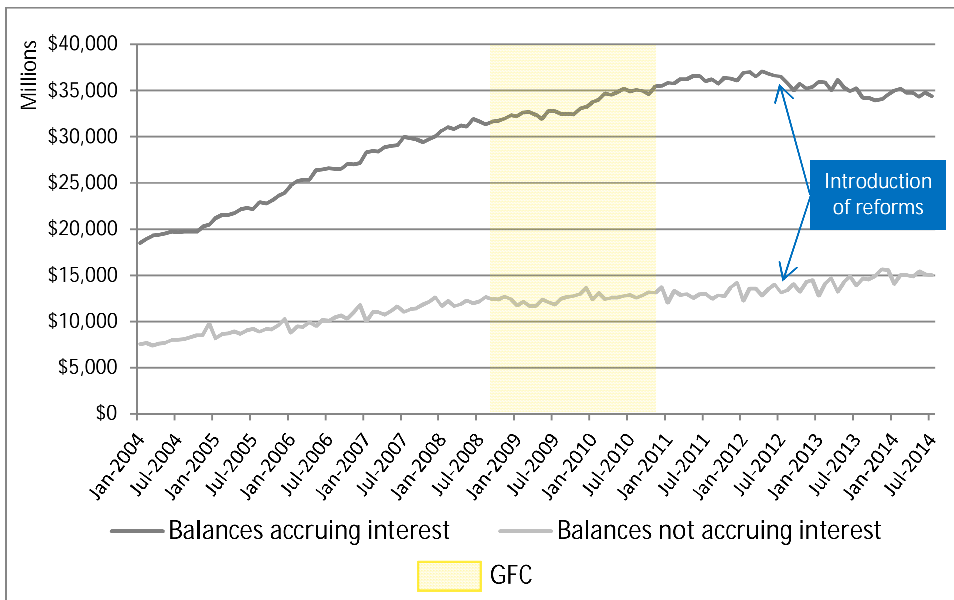
Where this might be most visible is in a reduction in the proportion of credit card debt that actually attracts interest charges – more effective management of credit card usage would see more consumers taking advantage of the interest free period offered. The tables below show total credit card balances broken down into that which accrues interest and that which does not by the percent split (Table 3)

Figure 2: Credit card balances: share of interest and not interest accruing balances (%)



Source: RBA, "Credit and Charge Card Statistics – C1", October 2014

Figure 3: Credit card balances: share of interest and not interest accruing balances ($)



Source: RBA, "Credit and Charge Card Statistics – C1", October 2014

As shown in Figure 6, the percent split between the interest accruing and non-interest accruing balances has remained relatively stable over the last ten years but does a slight deterioration post the GFC with a reversal occurring around the period the reforms were introduced. Figure 7 confirms this minor trend as a result of a slight decrease in the balances of debt accruing interest and an increase in balances not accruing interest following implementation of the Reforms in nominal dollar terms. Table 3 below presents balances two years prior to the Reforms and two year after the Reforms to track any change in behaviour throughout this time period.

Table 4: Detailed breakdown of credit card balances accruing and not accruing interest (July 2010 – July 2014)

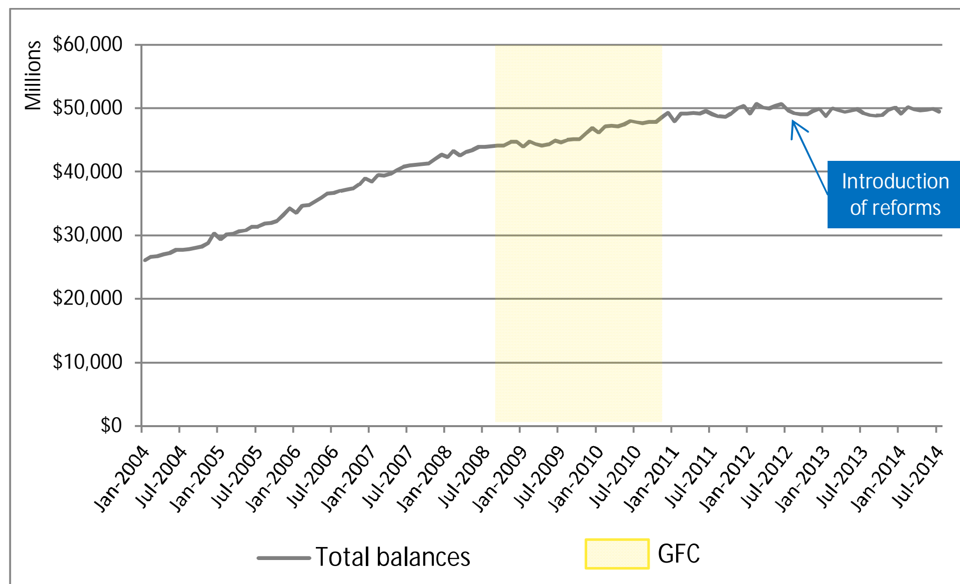
	Balances accruing interest ($m)	Balances accruing interest % of total balances	Balances not accruing interest ($m)	Balances not accruing interest % of total balances
Jul-2010	$34,936	73.08%	$12,872	26.92%
YOY % change	-	-	-	-
Jul-2011	$36,021	73.45%	$13,023	26.55%
YOY % change	*3.11%*	*0.51%*	*1.17%*	*-1.38%*
Jul-2012	$36,558	73.60%	$13,112	26.40%
YOY % change	*1.49%*	*0.21%*	*0.68%*	*-0.59%*
Jul-2013	$35,278	71.72%	$13,911	28.28%
YOY % change	*-3.50%*	*-2.56%*	*6.09%*	*7.13%*
Jul-2014	$34,407	69.61%	$15,022	30.39%
YOY % change	*-2.47%*	*-2.94%*	*7.99%*	*7.46%*

Source: RBA, "Credit and Charge Card Statistics – C1", October 2014

It is estimated that there was a $120m savings (or average monthly savings of $9.99m) in avoided interest expense in the 12 months following implantation of the Reforms.[18] Both the total balances (in dollar terms) and the proportion of balances not accruing interest exhibited year-over-year (YOY) growth post July 2012. Similarly, balances accruing interest decreased in both dollar terms and percent terms post July 2012. This indicates the Reforms may have had some impact on consumers taking advantage of interest free periods through better informed decision making and is evidenced by avoided interest costs.

Any changes in the distribution of balances must be reconciled with the fact that total credit card debt plateaued in real terms. Reviewing total credit card balances is another useful indicator in assessing the Reforms as it provides a holistic view of an individual's total credit card liabilities. A time series analysis of total balances over the past 10 years is presented below.

Figure 4: Total credit card balances ($)



Source: RBA, "Credit and Charge Card Statistics – C1", October 2014

In the 12 months prior to introduction of the reforms, total balances increased approximately 1.28%; and in the 12 months following the reforms, balances decreased -0.97%.

Cumulatively, analysis of both indicators – the proportion of balances accumulating debt and the overall growth in balances – may indicate that the Reforms had some effect on consumer behaviour. However,

[18] This has been calculated as the decreased share of interest bearing debt on a monthly basis compared to the average monthly share in the prior financial year. The average credit card interest rate was then applied to this share of debt expressed in dollar terms.

as with many analyses, it is difficult to distinguish cause and correlation without knowing the motivation for credit card spend. Whilst one can reasonably point to avoided interest fees following implementation of the Reforms, it may be tenuous at best to associate any plateau in total balances with the Reforms viewed in the greater context of trends coming out of the GFC.

5.1.3 Improved consumer adaptability and cost minimisation behaviour

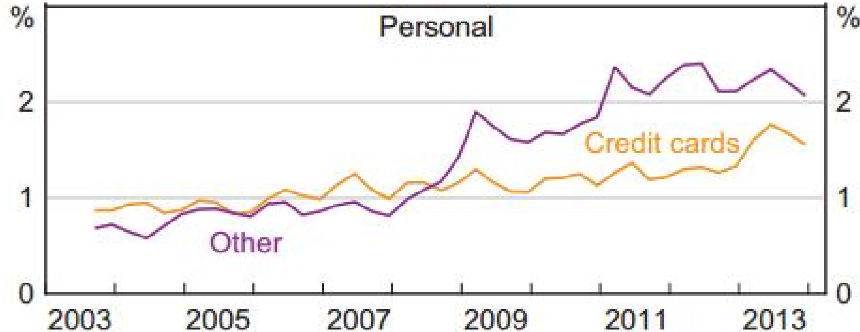
Similar to the concepts set out in 5.1.1 we would expect to see greater awareness of the cost differentials between finance options to lead to more active consideration by consumers of the option open to them. This would typically result in greater volatility between consumer debt across various products as they optimise their overall usage of the product profiles.

Our analysis did not detect any material trends in these measures that could be reasonably attributed to the time period post the implementation of the reforms.

5.1.4 Reduction in consumers financially overcommitting to credit they cannot afford

Perhaps the strongest indicator of consumers making informed and prudent financial decisions is the ability to meet credit card payments on time. Where there is a material reduction in both the overall consumer debt obligations and the effective interest paid on debt obligations it would be expected that there would be a similar reduction in the proportion of consumers who suffer financial stress. In sum, has there been a change in the levels of 'bad debt' since implementation of the Reforms? Figure 5 below shows non-performance on banks' credit cards and other personal lending.

Figure 5: Banks' non-performing loans by household (share of loans by type)



Source: RBA, *Financial Sustainability Review*, Household and Business Finances, p. 39, March 2014

The graph indicates a steep increase in non-credit card non-performing debt around the time of the GFC with no appreciable change correlated with the implementation of the reforms. This tends to support a view that the reforms did not produce a material longer term impact.

5.2 Summary of Benefits

The Commonwealth Government viewed the key drive to the implementation of Key Facts Sheets as:

> *Consumer understanding of term and conditions, core features of a credit product is dependent upon the respective consumer's level of financial literacy*[19]*. Information relating to credit products (for instance details in respect to fees, repayments and general terms and conditions) can be lengthy, complicated and technical. Therefore, consumers, particularly those with lower levels of financial literacy, may miss important information which if they had could have altered their decision making process.*

[19] Sheehan, G Wilson, T and Howell, N Coming to grips with credit contracts – Steps to protect vulnerable borrowers, Brotherhood of St. Laurence and Griffith University, November 2008, pp 4-5

The Commonwealth Government concluded that provisions of simpler and clearer disclosure documents, that is a "Key Fact Sheet", would make is easier for consumers with lower levels of financial literacy to understand credit products, assisting them in making rational/unbiased and better informed decisions in relation to credit card products.

Our analysis detected some changes in economic indicators that could support a view that the additional information supplied to consumers triggered a change in behaviour in respect of the management of credit card debt products. This is primarily evidenced by the increased share of credit card balances that does not accrue debt. These changes did not indicate a substantial shift in market behaviour but could imply some effectiveness of the Reforms. Further detailed analysis will be required to understand the correlation more fully.

We note that additional information on product choices generally requires three key factors to produce measurable changes in behaviour:

- Recipients need to be incentivised to read the material provided
- Recipients need the background understanding to be able to assess the information and relate it to their current situation so that they can develop strategies to improve their financing choices
- Recipients need to have access to more cost efficient finance alternatives or the capacity to allocate additional disposable income to debt repayments to be able to improve the impact of high credit card interest

Whilst there may be some data indicating a small change in behaviour associated with the Reforms, the absence of any strong trend indicates that the credit card information initiatives either did not effectively target those most exposed to the high cost of credit card debt or that these households do not have alternatives or capacity to reduce their credit card debt substantially through increased repayments on the balance outstanding.

The key question that this raises from our viewpoint is whether there was detailed consideration by the Commonwealth in respect of how to best target different consumer segments through the overall dispersion of additional information on credit card terms. An issue of worthy of further study is whether credit card borrowers without sufficient financial strength to either replace or rapidly repay credit derived benefits from additional technical information on the products.

Appendix 2

“Know Your Customer” provisions

Commonwealth Treasury

October 2014

1. Executive Summary

1.1 Our scope of work

Ernst & Young ('EY' or 'we') has been engaged by the Commonwealth Department of the Treasury ('Treasury') to evaluate the direct and indirect costs and benefits of selected sections of the larger portfolio of legislation developed to regulate Australia's financial systems. This engagement is a component of the current Financial Systems Inquiry (FSI), charged with reviewing all elements of legislation that impacts on the efficient operation of the complete system.

1.2 Focus of this Analysis: "Know Your Customer"

The "Know Your Customer"[20] (KYC) provisions are an element of the legislation developed to minimise the opportunity for the Australian banking system to be utilised as a conduit for illegal monetary exchange transactions including money laundering and terrorism financing. The key legislation and regulations applicable to anti-money laundering (AML) and counter-terrorism financing, and which set out the KYC provisions, are:

- *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF Act)
- *Anti-Money Laundering and Counter-Terrorism Financing Regulation 2014* (Regulations)
- *Anti-Money Laundering and Counter-Terrorism Financing Rules Instrument 2007* (No. 1) (Rules)

The framework outlined above establishes AUSTRAC as regulator. AUSTRAC is responsible for monitoring the compliance of Australian businesses to ensure they meet their legislative and regulatory requirements in relation to the prevention of anti-money laundering and counter terrorism financing.

1.3 Costs of the Provisions

Based on a literature review and our consultation process, we have identified the following elements of the KYC provisions that could impose additional costs on the market:

- Direct implementation costs – The KYC provisions potentially create an additional layer of verification that must be performed by a regulated service provider (reporting entity) prior to providing any Designated Service to a potential customer. This may increase the time and internal staffing costs of market participants in initiating new customer relationships. It is noted that service providers cannot rely on the verification process of other providers (without the existence of contracted cross-validation prcesses) – they must independently verify each new customer. These costs have been largely benchmarked through review of publicly available data.
- Ongoing Compliance – Regulated service providers are required to actively monitor transaction activity as well as report on their compliance with the relevant legislation and regulation and on certain transaction classes and other suspicions activity. This requires the development and maintenance of IT and internal process systems to support these requirements. These costs have been largely benchmarked through review of publicly available data.

We note that the available benchmarks on AML costs gave wide variation in the cost proportion attributable to the KYC elements. Estimates ranged from 11% to 39% of ongoing compliance costs

[20] EY is subject to a wide range of these provisions across its global network

and thus we have chosen to quote estimates of the overall cost ranges of the entire AML provisions The table below sets out the annual costs estimated for each element above in 2014 dollars.

Item	Cost Range	
Implementation Costs	$647m	$1.023b

tem	Broad Annual Cost Range Estimate	
Direct regulatory administration costs	$65.0m	$65.0m
Ongoing Private Sector Compliance	$234.2m	$370.3m
Total incremental annual costs	$299.2m	$435.3m

1.4 Potential Benefits of the Provisions

The aim of the KYC provisions is largely protective: the framework seeks to limit criminal access to key Australian money flow conduits and to minimise the opportunities for participants to avoid other regulatory obligations by disguising the nature of system cash flows . The benefits assessed are therefore connected to the utility in sustaining a financial system where there is a high degree of trust and visibility over the legal nature of financial transactions and largely qualitative in nature.

Based on our consultation process as well as the literature review that has been conducted, we have identified the following elements as the key benefits of the KYC provisions:

- Reduction in money flows stemming from illegal activity -- Effective regulation makes it more difficult for criminal participants to route cash flows through the Australian financial system
- Reduction in participant risk exposure -Systematic risk is reduced for all parties when there is greater confidence that financial flows do not represent inappropriate or illegal transactions
- Additional efficiency in tracking cash flows through the economy – Greater transparency over the source and destination of significant cash movements permits all Commonwealth agencies to more efficiently assess the . The 2012-2013 AUSTRAC annual report refers to additional income tax assessments of $521million that resulted in part from AUSTRAC sharing transaction data with the ATO
- Australia's reputation as a secure financial centre – Failure to implement effective anti-money laundering and counter terrorism regulation in accordance with international treaty requirements would potentially damage Australia's reputation and position as a secure destination and conduit for international capital flows.

1.5 Summary of our analysis

AML legislation is an essential part of the financial system regulatory framework. The approach taken by the Commonwealth in the structure of the AML framework is not inconsistent with those implemented in other similar regimes, (though perhaps more complex from a rule based perspective). We therefore do not expect the regulatory cost burden to be outside the range indicated from the global precedents observed and as a result believe that a reasonable estimate of the annual cost of the AML system is between $299.2m to $435.3m. This does not include any remediation costs of entities required to correct or improve their systems as a result of sanctions or compliance reviews.

The benefits of the legislation are potentially substantial from a qualitative viewpoint since the possession of a compliant AML process is a prerequisite to the development of efficient financial system interactions with our major trading partners. We note that recent enforcement actions

against firms suspected of supporting overseas terrorist entities demonstrates the role that the increasing sophistication available to AUSTRAC in tracking cash flow patterns can play in providing a secure financial system. The level of activity of AUSTRAC in assessing suspicious transaction highlights the potential for illegal activity to proliferate if there was no monitoring system in place.

Measuring the quantitative benefits in respect of the core AML provisions is difficult. While there are broad estimates of the size of the Australian "black economy" we are unable to source any public data on the impact AML provisions may have had on reducing the growth of this illegal financial sector. The key quantitative benefits that are likely to be measurable are those derived from AUSTRAC sharing transaction data with other Commonwealth agencies including the ATO , the Department of Human Services, the various State and Commonwealth law enforcement entities and overseas financial intelligence and Law enforcement agencies.

The note in the 2012-13 Annual Report on the role of AUSTRAC on their role in the identification of additional income tax assessments of $521m is a clear example of the potential for the AML framework to generate substantial, recurrent financial benefits to taxpayers. Focused periodic reporting on the positive financial impacts of AUSTRAC actions would assist in emphasising the value of the AML controls while highlighting the risks of attempting to breach the integrity of the Australian financial system.

A significant risk identified in respect of the future path of the AML framework lies in its substantial complexity. A common theme in global reports on participant views on AML legislation is that market participants fear that any new challenges to the integrity of financial systems will be met with increasingly complex "black letter" regulation that will lead to spiralling compliance costs.

A key issue in respect of future AML revisions is therefore likely to setting an appropriate balance between "Rule Based" and "Risk Based" provisions-

Rule Based regulation involves the regulator setting out in detail the actions a covered entity must take meet its obligations. This requires that the regulator have a very complete understanding of both current market practices and the low level activities that participants must adapt to comply with the new legislation. The key risk in this approach is specification risk: where the regulator primarily defines compliance with respect to legislative provisions it is possible that there are gaps in the coverage and thus options for entities to structure activities around the regulation and still be technically compliant. This approach also tends not to be scalable between smaller entities such as a hotel with limited gambling facilities and a major bank and may not effectively distinguish between the risks involved in different entity types.

Risk Based regulation is based around a regulator clearly defining the overall obligations of a market participant through detailed commercial principles and hence makes participants responsible for demonstrating that their response is compliant with these principles. This needs the regulator to have access to experienced resources in reviewing compliance reporting and identifying where there are issues requiring further investigation. Risk based structures can be more flexible since they rely on commercial principles as the basis of regulation and thus allow a regulator to respond to market developments without the need to rapidly draft new detailed provisions to deal with new threats.

There is an opportunity for the Commonwealth to investigate the potential to build on the core rule based structure of the AML through risk based revisions and look to avoid the risk of developing an increasing complex and rigid AML system that cannot be easily adapted to rapid market changes.

One other element that arose in discussion was the potential to streamline identity management through the Commonwealth consolidating the identity confirmation requirements into a single clearing house. It was noted that there is considerable overlap between AUSTRAC, the ATO, ASIC and other agencies that deal with taxpayer/benefit recipient identity processing and that a Commonwealth controlled process that allowed sharing across both agencies and market participants would increase the efficiency of the overall system.

2. Introduction

2.1 Our scope of work

We have been engaged by Treasury to evaluate the direct and indirect costs and benefits of selected sections of the larger portfolio of legislation developed to regulate Australia's financial systems. This engagement is a component of the current Financial Systems Inquiry (FSI), charged with reviewing all elements of legislation that impacts on the efficient operation of the complete system

2.2 Our approach

The key tasks which we undertook to complete this engagement included the following:

- A literature review of the data available on the international experience in implementing and managing legislation aimed at controlling money flows ultimately derived from, or directed to, criminal activity
- A consultation process with Australian financial market participants to derive estimates of the full cost of complying with the legislation
- Where possible review and analyses of key Australian economic and financial market data sets to produce estimates of the quantifiable benefits of the legislation
- Developed a rapid cost/benefit analysis of the legislation where the quantification of costs and benefits provides sufficient confidence that the most significant factors have been identified
- Outline and qualitatively assess other costs and benefits for which reliable quantitative estimates cannot be developed

2.2.1 Limitations of this report

This report is subject to the following limitations:

- We have relied on representations made to us by key stakeholders in the financial sector during the course of interviews and meetings. These representations have not been independently verified or validated by us
- The observations that we have made and documented in this Report are, by necessity, limited and qualified to reflect a number of factors. These include the limited time available to undertake our assessment, our terms of reference, and the reliance being placed on information provided to us which we have not been asked to independently verify
- We did not undertake any analysis to determine the appropriateness or correctness of the inputs and assumptions into this analysis
- We offer no view on the overall appropriateness or effectiveness of the regulation analysed in this report

2.3 Structure of this report

The remainder of this report is set out as follows:

- Chapter 3 – Provides the context to the analysis performed
- Chapter 4 – Analyses the expected costs of the provisions
- Chapter 5 – Analyses the potential benefits of the provisions

- Appendix A – Summarises selected overseas KYC regimes

3. Overview

Summary of comments from the consultation process

- Available public reports highlight market concerns with the increasing complexity of AML legislation as it is amended to adapt to increasing financial system risks. There is a fear that compliance will become very difficult to substantiate with an increased risk of substantial sanction for breaches that are essentially technical in nature.
- Compliance risk is especially felt at the smaller end of the market where owners do not have the skills or time to review and understand the legislation.
- There is increasing risk through potential divergence of international regimes as countries develop individual legislation amendments.
- Financial Exclusion is a risk of compliance complexity that is the creation of a class of customer that banks consider too risky and expensive to verify and monitor.
- These concerns highlight the tension between risk and rule based approaches to complex regulatory issues. Comments were made that countries risk ending up with AML legislation that matched the complexity of the taxation provisions.
- There was support for the consolidation of Australian identity verification requirements across all government agencies into a single government controlled identity "clearing house" this would allow private sector entities to rely on a central verification process and minimise unnecessary duplication of time consuming processes.
- There was a clear recognition that AML legislation was essential but that earlier consultation on coverage and structure would have produced more efficient regulation. The example was given that tax agents are not covered and that advice sought at this level can be an enabler for future inappropriate structuring.

Australia's anti-money laundering and counter terrorism financing regulatory regime (AML/CTF regime) has been established to prevent, deter and detect terrorism financing and money laundering. The subject of this Report, the KYC provisions, is established by this framework. These provisions set out a number of requirements regulated financial service providers must adhere to when dealing with their customers.

This chapter seeks to:

- Define money laundering and terrorist financing
- Provide an abridged background to the establishment of the AML/CTF regime
- Set out the reasoning for why the AML/CTF regime was introduced
- Define the components and operation of the regulatory AML/CTF framework and its objectives
- Describe to which entities the framework applies
- Sets out the specific requirements of the KYC provisions, which is the primary subject of the subsequent cost and benefit analysis

3.1 Money laundering and terrorism financing defined

Money laundering and terrorism financing involves funds raised through or for illegal activity. To understand the rationale behind the establishment of the AML/CTF regime, including the KYC provisions, it is useful to provide a brief description of money laundering and terrorism financing.

The International Monetary Fund (IMF) describes money laundering as the process by which funds or other types of assets obtained from criminal activity are filtered through the financial system in order to conceal how the funds were generated i.e. severing the link between the funds and the criminal activity. The types of criminal activity that generate financial proceeds that require laundering include; white collar crimes (e.g. fraud and embezzlement), drug related, internet based fraud, taxation evasion, bribery and corruption[21].

Terrorist financing involves raising and supplying terrorists with resources and assets to assist them in pursing terrorist activities[22]. Some of the types of activities funded include; training, combat, attacks, and promotion of extreme ideologies[23]. Terrorist financing can originate from legal (e.g. charities and small cash-intensive businesses) and illegal sources (fraud, trafficking in narcotics, weapons, humans, diamonds and petty crime).

Due to the illegal and opaque nature of money laundering and terrorism financing it is difficult to estimate the quantum of these activities. The Australian Institute of Criminology estimates that more than $1.5 trillion of illegal funds are laundered worldwide each year with around $4.5 billion in Australia[24]. AUSTRAC estimates the amount of money laundered in Australia at around $10 billion each year[25].

3.2 Background

In 1989 an inter-governmental policy-making body known as the Financial Action Task Force (FATF) was established. In short, the FATF "set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system"[26]. The FATF focuses on the following three core activities:

- "Setting the global standards to combat money laundering and terrorism financing
- Ensuring effective compliance with these standards through the mutual evaluation process
- Identifying money laundering and terrorism financing methods and trends"[27]

Australia is a founding member of the FATF and in 2005 the FATF evaluated Australia's AML/CTF regime. The FATF found it to be significantly non-compliant with about half of its recommendations. Australia was seriously lagging behind international best practice and to address the inadequacies (identified the FATF's review) a new regulatory package, including the AML/CTF Act, was introduced in 2006. This package was designed to strengthen Australia's regulatory regime by bringing it into line with the international standards set by the FATF's member countries (2013 OECD report shows a much improved picture).

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[21] FATF Report Global Money Laundering and Terrorist Financing Threat Assessment report

[22] http://www.imf.org/external/np/exr/facts/aml.htm

[23] FATF Report Global Money Laundering and Terrorist Financing Threat Assessment report

[24] http://www.aic.gov.au/crime_types/transnational/moneylaundering.html

[25] Australian Transaction Reports and Analysis Centre (AUSTRAC) 2011, Money laundering in Australia 2011, viewed on 16 June 2012, http://www.austrac.gov.au/files/money_laundering_in_australia_2011.pdf

[26] http://www.fatf-gafi.org/pages/aboutus/

[27] FATF Report, Money Laundering and Terrorism Financing Threat Assessment, July 2010

3.2.1 Rationale for the AML/CTF regime

Money laundering and terrorism financing activities help to enable organised and serious criminal activity, which can result in significant social and economic consequences. For instance, the prevalence of these activities can:

- Undermine and threaten the stability and integrity of financial institutions and system
- Distort international capital flows
- Discourage foreign investment
- Impact a country's macroeconomic performance by draining resources from more productive activities resulting in lost productivity improvements and economic growth
- Entice individuals and businesses to engage in corrupt behaviour
- Impact community safety and wellbeing by further funding other criminal activities[28]

In short, the AML/CTF regime seeks to deter money laundering and terrorism financing from occurring in Australia thereby reducing or eliminating the associated negative social and economic impacts. The regime enables law and enforcement bodies, government and regulators to work alongside industry to identify, disrupt and prevent money laundering and terrorism financing. It also helps to protect industry and members of the community from criminal abuse. The rationale for establishing this regime also extends beyond crime reduction and social benefits; it also assists in ensuring Australia's financial system remains robust, maintains its reputation as a safe place to do business and continues to be a desired place for foreign businesses to invest in.

3.2.2 Legislative framework

Like all regulatory measures, the AML/CTF legislative framework seeks to achieve a balance between the reality of the day-to-day operations of impacted industries and the Commonwealth Government's obligations to meet international standards. The framework is comprised of legislation and associated regulations, rules and policy principals. A brief description of each of these elements and the role of AUSTRAC and the Attorney-General's Department (AGD) follows.

- AML/CTF ACT – provides a legislative and regulatory framework and obligations which regulated entities must adhere to
- Regulations – section 255 of the AML/CTF Act allows for the Governor-General to make regulations to give effect to a specific provision in the AML/CTF Act and/or respond to technical issues
- Rules – section 229 of the AML/CTF Act allows for AUSTRAC's Chief Executive Officer to make rules in consultation with relevant government agencies, industry and other stakeholders. Rules are binding legislative instruments which set out specific requirements that support the operation of the AML/CTF Act
- Policy Principles – section 213 of the AML/CTF Act allows for the Minister to issue policy principles which are binding on AUSTRAC in the performance of its functions
- AUSTRAC – is Australia's counter terrorism financing and anti-money laundering regulator, and is responsible for regulating entities in accordance with the AML/CTF regime. AUSTRAC:

[28] Australian Crime Commission, Crime Profile Series - Money Laundering, July 2013

- Test whether any obligation imposed on reporting businesses is proportionate to the level of money laundering and/or terrorism risk and does not adversely impair economic efficiency, competition, and/or competitive neutrality
- Is required to provide advice and guidance to reporting entities on meeting their duties and obligations under the framework, and "to improve their compliance with obligations under the AML/CTF Act"[29]
- Is responsible for monitoring compliance of reporting entities and undertaking enforcement action where appropriate. Non-compliance can attract remedial directions as stipulated by AUSTRAC and in some cases civil penalties

- AGD – AGD is responsible for implementing the Commonwealth Government's anti-money laundering and counter terrorism policies. For instance, AGD is currently conducting a statutory review of the AML/CTF Act (in accordance with section 251). The Review is examining: operations of the regime; appropriateness of the policy objectives; and whether the legislative provisions adequately support the achievement of those objectives[30]

3.2.3 Objectives of the AML/CTF regime

The AML/CTF Act endeavours to provide a workable legislative framework that strikes a balance between efficient conduct of business and effective regulation to combat money laundering and terrorism financing within Australia.

Section three of the AML/CTF Act explicitly states the following objectives:

- To fulfil Australia's international obligations, international Contraventions and United Nations Resolutions by which Australia is bound, to combat money laundering and financing of terrorism
- To address matters of international concerns (for instance various international instruments) in regards to the need to combat money laundering and financing of terrorism by which Australia is bound
- To strengthen Australia's relationships with international organisations and foreign countries

The framework imposes a number of obligations on regulated financial institutions under the following five key areas, which are recognised international as best practice.

Conduct a risk assessment – a business (regulated entities) must understand and manage the potential risks arising from money laundering and terrorist financing they are exposed to when providing financial services and products, operating in different jurisdictions, dealing with differing customers, and/or using different distributions channels.

Implement systems and governance to manage their risks – businesses must put in place appropriate diligence programs and ensure that staff are trained to detect money laundering and terrorism financing behaviour. They must also regularly review the effectiveness of their systems and compliance with their obligations.

Know their customers – businesses must verify the identity of their customers, monitor behaviour, keep appropriate records of their actions. Regulated entities must also appropriately identify any other regulated entity with which they do business.

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[29] AUSTRAC 2012-13 Annual Report

[30] http://www.ag.gov.au/Consultations/Pages/StatReviewAntiMoneyLaunderingCounterTerrorismFinActCth2006.aspx

Make themselves known to AUSTRAC – all regulated entities (businesses providing a designated service) must be enrolled on the Reporting Entities Roll, which is maintain by AUSTRAC.

Report to AUSTRAC – businesses must report on their compliance with the AML/CTF regime, cash transactions of AUD10,000 or more, suspicious matters and report international funds transfer instructions.[31]

Implicitly, the AML/CTF regime seeks establish a framework that:

- Supports international and domestic efforts to combat terrorist and organised crime, which is consistent with international best practice
- Diminishes the risks associated with money laundering and terrorist financing occurring in the Australian economy
- Does not inflict any unnecessary burden on regulated entities[32]

3.2.4 Scope of the AML/CTF regime

The AML/CTF regime applies to four industries (described below) when regulated businesses within these industries provide a designated service to a consumer.

Industry	Description	Approximate enrolled entities[33]
Non-bank financial services	Large to small businesses that provide a wide range of services. Examples of businesses include; financial planning, stockbroking, superannuation, life insurance, and funds management.	2,600
Bullion and gambling	Typically smaller sized businesses. Examples of businesses include; casinos, hotels, clubs with electronic gambling machines, and bookmakers	4,300
Banks and other lenders	Typically well-resourced businesses that are accustomed to operating in a regulated environment. Examples of businesses include; authorized deposit-taking institutions (ADIs) – foreign, domestic banks, credit unions, subsidiaries, micro-lenders, building societies.	1,100
Money service businesses	Businesses include remittance service providers, currency exchange dealers, and cash carriers.	5,500

The population of regulated businesses "ranges from large sophisticated and well-resourced global corporations, such as domestic and foreign banks, to sole proprietor and micro businesses with limited resources"[34]. In 2013, AGD and AUSTRAC estimated that 70 per cent of reporting entities were classified as small business (i.e. a business with 20 or fewer staff)[35].

Regulated entities have a number of obligations they must adhere to when providing designated services as prescribed by section six of the AML/CTF Act. Examples of designated services include; lending, gaming, bullion services and remittance and foreign exchange services.

[31] AUSTRAC's 2012-13 Annual Report
[32] Review of the AML/CTF Regime, Issue Paper, December 2013, AGD, AUSTRAC
[33] As at 30 June 2013, *AUSTRAC 2012-13 Annual Report*
[34] Review of the AML/CTF Regime, Issue Paper, December 2013, AGD, AUSTRAC
[35] Review of the AML/CTF Regime, Issue Paper, December 2013, AGD, AUSTRAC

3.3 The KYC provisions

The KYC requirements refer to the processes regulated financial service providers (regulated entities) must carry out in order to correctly identify their clients prior to conducting financial business with them. Under the requirements financial service providers must monitor customers' behaviour, maintain appropriate records of their actions, and identify any other financial service provider they do business with.

The intent of the KYC provisions is to assist in deterring criminals from using financial services and products for money laundering and terrorism financing. The provisions are established by the AML/CTF legislative and regulatory framework and therefore underpinned by the AML/CTF Act's objectives (see section 3.2.3).

Specifically, regulated service providers are required to:

- Properly identify a customer and understand the risks a customer may pose before providing a designated service to the customer[36]
- Use reliable and independent documentation and/or data to verify the identity of a customer
- Only accept legitimate and bona fide customers
- Monitor customer accounts and transactions to prevent or detect illegal activities
- Implement processes to effectively manage the risks posed by a customer trying to misuse facilities[37]

3.4 Global examples

As part of our analysis we reviewed 4 international KYC regimes to test whether the Australian structure adopted a similar approach. The 4 regimes reviewed were the USA,UK, Germany and India (detailed summaries of these regimes are set out in Appendix B) and in general there is substantial consistency between provisions between the Australian structure and the overseas regimes. This is to be expected, the more consistent are global AML provisions then the more efficient it is for global firms to navigate the various regimes and centralise compliance and monitoring functions and the more effective cross-border enforcement actions will be.

The complexity in AML provisions appears to be inherent in this type of regulatory framework rather than an artefact of the Australian version and thus we consider that it is reasonable to estimate Australian system costs using available global benchmarks

[36] Customers include; individual, companies (domestic and foreign), trustees, partnerships, incorporated and unincorporated associations, registered co-operatives and government bodies

[37] http://www.austrac.gov.au/elearning/mod6/mod_6_know_your_customer_6.html

4. Identified Costs of the KYC Provisions

We have calibrated the limited data provided by market participants with existing publicly available analyses of the costs involved in the implementation an ongoing compliance with AML requirements. The basic similarity between the Australian legislation and global precedents provide a degree of confidence that estimates based on this approach will provide a reasonable view on the potential costs incurred in the Australian context.

Cost	Stakeholder	Measurement / required data
4.1.1 Administration and management of the anti-money laundering and counter terrorism financing policies, including KYC	Tax payer (AGD)	Commonwealth Budget Papers, Annual Reports
4.1.2 Investigation, enforcement and monitoring of non-compliance with KYC	Tax payer (AUSTRAC) Reporting entities	Commonwealth Budget Papers, Annual Reports
4.1.3 System development and maintenance of KYC procedures Development and management of internal policies and procedures to ensure requirements of KYC are met[38]	Reporting entities	Cost estimates of the initial development of KYC systems
4.1.4 Ongoing compliance	Reporting entities	Additional Staff costs, IT system upgrades System development costs

4.1.1 Administration and management of anti-money laundering and counter terrorism financing policies

The AML/CTF Act, Regulations, Rules and associated policies, including the KYC provisions, are administered the Commonwealth Government.

AGD is responsible for managing the Government's anti-money laundering and counter terrorism financing policies. This includes delivering and developing "programs and policies to maintain and improve Australia's law and justice framework"[39].

As a Commonwealth department, AGD is funded through the Commonwealth budgetary process and is ultimately financially supported by Australian taxpayers. The budget allocation in respect of these duties is through AUSTRAC, and thus we have assumed that the cost of the AGD involvement is reflected in the AUSTRAC funding allocation.

4.1.2 Investigation, enforcement and monitoring of non-compliance

As the Commonwealth regulator, AUSTRAC is responsible for monitoring and enforcing compliance with the requirements of the AML/CTF regime, including the KYC provisions. As previously discussed in chapter three, the requirements of the KYC provisions include; implementing programs for identifying and monitoring customers and for managing the risks of money laundering and terrorism financing, reporting suspicious matters, threshold transactions and international funds transfer instructions, and submitting an annual compliance report.

[38] For example: employee due diligence and corporate intelligence capabilities, risk assessments, implementation and review of internal procedures, investigations, design and delivery of AML/CTF training programs, customer due diligence and transaction monitoring software

[39] www.ag.gov.au/about/pages/default.aspx

As an entity established by Commonwealth legislation, AUSTRAC receives its funding through Commonwealth budgetary process. However, AUSTRAC also recovers some of its costs through its cost recovery arrangements – the AUSTRAC Supervisory Cost Recovery Levy. This is proposed to change post the 2014 budget to an industry contribution.

The funding allocation to AUSTRAC via the Commonwealth 2013-14 budgets was approximately $65 million and we have adopted this as an appropriate estimate of the overall direct regulatory cost borne by taxpayers. We have excluded the element of AUSTRAC's regulatory costs recovered from industry[40] since this cost is captured in our estimate of the ongoing industry compliance costs.

There is no publicly available information on what proportion of AUSTRAC's annual appropriation and amount of revenue raised from the Supervisory Cost Recovery Levy is specifically directed towards the investigation and enforcement of and the monitoring of compliance with the KYC provisions.

Magnitude of AUSTRAC's 2012-13 Regulatory Operations

- Received 84,634,614 financial transaction reports (equating to an average of 325,5000 transaction reports per business day), which was an increase of 43 percent in volume compared to 2011-12
- Received more than 40,000 suspicious matter reports, representing a marginal decrease on the previous financial year
- AUSTRAC information assisted law enforcement, intelligence, human services, regulatory and revenue partner agencies in 280 other significant investigations
- AUSTRAC exchanged financial intelligence with 66 international counterparts on more than 240 occasions (including both incoming and outgoing exchanges)
- In the 2012 AML/CTF compliance report there was an increase in reporting entities indicating they have fully implemented AML/CTF programs in place, from 91 percent to 95 percent
- Issued 141 compliance assessment reports, which included 840 requirements to rectify identified areas of non-compliance, and 347 recommendations to improve entities' AML/CTF policies, procedures, controls and systems.

4.1.3 System development of KYC procedures

A key element of the KYC processes is a completely new compliance layer that covered the additional reporting provision and processing. It was noted that the implementation of the Financial Transaction Reports Act in 1988(the original 100 point check) meant that entities covered by the new KYC provisions had already developed low level processes aimed at more thorough verification of potential new customers that could form the basis of the KYC structure, though the following activities may still been required:

- Development and distribution of updated customer verification procedures
- Development of training for relevant staff members, this could also include online courses
- Development of record-keeping requirements for records relating to identification procedures

[40] AUSTRAC Annual Report 2012-13

► Procedures for reporting suspicious matters and producing periodic compliance reports

4.1.4 Ongoing compliance

The overall AML framework requires covered entities to provide extensive compliance and exception reporting as well as ensure all staff are trained in the current AML processes and obligations. Reporting entities must assist AUSTRAC and any criminal investigation agencies in further assessing any suspicious transaction reported. Global experience is that this is a significant additional cost when assessed over the full AML regulatory package.

4.2 Summary of costs

The available public data on the implementation and ongoing costs imposed by AML frameworks is limited. Few jurisdictions have commissioned independent analyses and private sector entities rarely disaggregate these costs when reporting their year-end results. We have therefore relied primarily on three analyses in developing a cost estimate for the recurrent and initial private sector costs in respect of AML provisions:

1. ANTI-MONEY LAUNDERING REQUIREMENTS: COSTS, BENEFITS AND PERCEPTIONS (a 2005 report produced by Z/Yen ltd sponsored by the Institute of Chartered Accountants in England and Wales and the Corporation of London); and

2. Ministry of Justice New Zealand: Assessment of business compliance costs of the indicative anti-money laundering regulatory requirements (a 2008 analysis produced by Deloitte)

3. Trends in Anti-Money Laundering 2011 (a report published by Celent with data on USA banking AML compliance costs)

The first report produced estimates of the cost of AML provision as a proportion of GDP for US,UK, Germany, France and Italy. This highlighted the relative inefficiency of the UK experience (though this could be explained by the wide coverage of the UK provisions) with the following table of broad estimates provided

Country	Estimated AML Compliance Costs as a % of GDP
USA	0.021%
UK	0.026%
Germany	0.012%
France	0.009%
Italy	0.009%

The second report was an extensive analysis on the reported costs of NZ parties in implementing AML systems and the ongoing impost of complying with AML regulations. The report produced a central estimate of the yearly compliance costs of NZ$41.7 million in 2008 terms. This is equivalent to a share of 2008 NZ GDP of 0.0237%.

The third report produced estimates of the annual AML compliance costs of US banks in as a % of bank asset values. The report estimated the percentage to be between 0.005% and 0.01% for banks with asset above US1.0 billion.

The table below details estimates of the annual compliance costs based on using the parameters derived from the three reports above.

Benchmark Value	Rationale	Annual Compliance Cost Estimate from the Bnechmark
0.015% of GDP	Midpoint of AML GDP %'s derived in the Z/Yen reports	$234.2m
0.0075% of non-superannuation financial assets	Midpoint of the financial asset measures reported in the Celent report	$320.8m
0.0237% of GDP	Assumes that Australian financial system is similar in complexity to the NZ system Derived value from the Deloitte report	$370.3m

Our range on the total economic costs of annual ALM costs is therefore the low and high points above plus the assumed estimate annual Commonwealth funding of $65m: $299.2m to $435.3m

Applying the observed NZ multiple on start-ups versus ongoing costs would produce a range of $647m to $1.023b.

We note that these estimates do not include additional costs incurred by reporting entities in remedial activities in improving their systems as result of compliance reviews.

5. Benefits of the KYC Provisions

Based on our consultation process as well as the literature review, the following benefits that AML regulation is expected to generate include:

Benefit	Stakeholder	Measurement / required data
5.1.1 Reduction in money flows stemming from illegal activity	Australian Economy	Qualitative only
5.1.2 Reduced participant risk exposure	Reporting entities	Qualitative only
5.1.3 Additional efficiency in tracking cash flows through the economy	Reporting entities	Additional revenue generated from Taxation/Benefit recoupment
5.1.4 Australia's reputation as a secure financial centre	Australian economy	Qualitative Only

5.1.1 Reduction in money flows stemming from illegal activity

Effective AML legislation may assist in reducing the direct impacts of more widespread money laundering activity including:

- 'Crowding out' legitimate businesses in the marketplace when money laundering front businesses subsidies products and services at levels well below market rates
- Affecting the reputation and integrity of financial institutions where they become involved, usually without knowing, with the proceeds of illegal activity
- Corrupting individuals and undermining checks and controls within institutions and businesses used to channel laundered funds
- Assisting in the financing of terrorism
- Financing and providing motivation for further criminal activities[41]

An important factor mentioned in respect of effective regulation is that criminal elements do assess the risk of being caught in initiating illegal activity. A regulator proactively engaging with the media to demonstrate a high level of market coverage amplifies the perception of risk. The level of activity demonstrated by AUSTRAC could be more widely disseminated to increase the market awareness of its role and coverage.

5.1.2 Reduced participant risk exposure

Effective AML legislation potentially reduces the level of overall risk to market participants in the following areas:

- Reputational risk: the risk that a customer of a (otherwise) reputable business undertakes an illegal activity or transaction through that business that results irreparable damage to that businesses reputation
- Operational risk: the risk of indirect or direct loss incurred from failed internal processes. A

[41] https://www.crimecommission.gov.au/publications/intelligence-products/crime-profile-fact-sheets/money-laundering

flawed or non-existent KYC policy or poor implementation of that policy can lead to wasted resources and increased chance of a services being used illegally

- Regulatory risk: the risk that a company is used for an illegal purpose which then results in that company incurring penalties, fines, injunctions and in extreme cases forced discontinuation of operations
- credit risk: the risk that an entity (person or business) risk that a company lends money to an entity (person or business) for illegal reasons and then that money is unable to be retrieved
- Concentration risk: the risk that a company has too much exposure to one particular class of asset or liability therefore exposing the business to risk in the event of loss
- Competitive disadvantage to other countries should Australia be subject to some form of Blacklist for not adequately complying with international standards.
-

5.1.3 Additional efficiency in tracking cash flows throughout the Australian economy

The information sharing protocols between AUSTRAC and partner agencies provide a strong basis for tracking and monitoring the financial flows through the system with a much wider regulatory ambit. Suspicious matters can be identified at an early stage through industry reporting and then analysed in detail to determine any risks to multiple Government funding conduits. The 2013 AUSTRAC report details a particular case study where this resulted in a income tax assessment of an additional $521m.

This benefit is open to periodic quantification: AUSTRAC could liaise with other agencies to produce annual reports detailing the activity detected and the financial benefits to taxpayers capture in the consequent enforcement activity. The current annual report provides case studies on how inter-agency cooperation has been effective, fuller reporting on the quantum of actions that result in the recovery of revenue would create a better picture of the role of AUSTRAC in the key regulatory function.

5.1.4 Australia's international reputation as a secure financial centre

A compliant AML framework is now seen as a fundamental requirement of an effective financial regulatory system.

5.2 Summary of Benefits

Available analysis on the impact of AML implementation is largely driven from the perspective of the market participants (for example, the annual KPMG Global AML Survey is an example of the periodic capture of market participant views focused on business impacts rather than the perceived effectiveness of AML regulation as a mechanism to minimise illegal activity). The benefits referred to above are frequently identified as the likely results of effective AML legislation but there is limited data on the relative impact of AML in generating these benefits.

There is now an increasing focus on assessing the impact of AML implementations: FATF is now seeking to include effectiveness reporting as well as compliance reporting in its country evaluations. Given the potential for AML legislation to increase in complexity and coverage and the likely impact on compliance costs it is reasonable to expect the Commonwealth to demonstrate the cost effectiveness of the current approach and have a clear view on the potential cost of future amendments to permit a more open consultation process.

What is clear in the Australian context is that the visibility AUSTRAC monitoring grants over the overall Australian financial system cash flows has the potential to enhance the effectiveness of revenue protection mechanisms across State and Commonwealth levels. The case studies provided by AUSTRAC indicate that there are significant potential financial benefits that can be realised through more diverse use of the tracking resources. Closer integration of these functions could be reviewed as part of the ongoing development of Australian AML regulation.

Appendix A: Summary of other KYC regimes

<table>
<tr><th>Country</th><th>KYC applicable or not</th><th>Relevant Act</th><th>Details of applicability</th></tr>
<tr><td>UK</td><td>Yes</td><td>Anti-Money Laundering (AML) regulations came into effect in 1994; amended in 2003, 2007; Changes to the Money Laundering Regulations 2007 came into effect from October 1, 2012.

UK will likely be covered by the 4th EU Directive as well</td><td>A. Regulator for AML controls includes:
1) Banking sector, other financial services: Financial Conduct Authority and Treasury
2) Non-financial services: HM Revenues and Customs; The Law Society; The Institute of Chartered Accountants in England and Wales

B. Thresholds for customer due diligence:
Transactions above EUR15,000 for TTR's

C. Verification requirements:
Individuals: full name, residential address and date of birth ideally from a government issued document which includes the customer's full name and photo, and either residential address or date of birth e.g. valid passport, valid photo card driving licence etc.; or a government issued document (without a photograph) which includes the customer's full name, supported by a second document, either a government-issued, or issued by a judicial authority, a public sector body or authority, a regulated utility company, or another FSA regulated firm in the UK financial services sector or in an equivalent jurisdiction, which includes the customer's full name and either residential address or date of birth.

Corporates (other than regulated firms): full name, registration number, registered office in country of incorporation, business address. Additionally, for private /unlisted companies: names of all directors (or equivalent), names of individuals who own or control over 25% of its shares or voting rights and names of any individual(s) who otherwise exercise control over the management of the company. The firm should verify the existence of the corporate from either a confirmation of the company's listing on a regulated market or a search of the relevant company registry or a copy of the company's Certificate of Incorporation. For private/unlisted companies, firms may decide, following a risk assessment, to verify one or more of the directors as appropriate in line with CDD requirements for individuals. In respect of Beneficial owners, the firm must take risk based and adequate measures to verify the identity of the Beneficial Owner(s).</td></tr>
</table>

Country	KYC applicable or not	Relevant Act	Details of applicability
			D. Circumstances that warrant enhanced customer due diligence measures: A firm must apply, on a risk-sensitive basis, enhanced customer due diligence measures and enhanced ongoing monitoring in any situation which by its nature can present a higher risk of money laundering or terrorist financing. Three specific types of relationships where enhanced due diligence measures must be applied are: a) where the customer has not been physically present for identification purposes; or b) in respect of a correspondent banking relationship with Respondents from non-European Economic Area ('EEA') states; or c) in respect of a business relationship or an occasional transaction with a Politically Exposed Person ('PEP'). E. Reporting: Suspicious Activity Reports (SARs) are made to Serious Organized Crime Agency (SOCA) TTRs Annual MLRO report

Country	KYC applicable or not	Relevant Act	Details of applicability
US	Yes	1970 – Congress passed the Currency and Foreign Transactions Reporting Act, commonly referred to as the Bank Secrecy Act (BSA) Other key laws are: a) Money Laundering Control Act (1986) b) Anti-Drug Abuse Act of 1988 c) Annunzio-Wylie Anti-Money Laundering Act (1992) d) Money Laundering Suppression Act (1994) e) Money Laundering and Financial Crimes Strategy Act (1998) f) Uniting and Strengthening America by Providing Appropriate Tools to Restrict, Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act) – the most significant amendment to the BSA g) Intelligence Reform & Terrorism Prevention Act of 2004 h) Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010	A. Regulator for AML controls includes: The Financial Crimes Enforcement Network (FinCEN) of the U.S. Treasury Department is the US regulator for AML regulations. FinCEN relies on other US regulators to apply and examine for compliance with FinCEN's regulations. These other regulators are as follows: a) Banking: Depending upon the type of banking charter an institution has, and its membership in the Federal Reserve System, a bank's federal regulator will be one of the following: a. Board of Governors of the Federal Reserve System (Fed) b. Office of the Comptroller of the Currency of the U.S. Treasury Department (OCC) c. Federal Deposit Insurance Corporation (FDIC) b) Other Financial Services: a. Credit Unions: National Credit Union Administration (NCUA) b. Broker Dealers: U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) c. Registered Mutual Funds: U.S. Securities and Exchange Commission d. Commodity and Futures Firms: U.S. Commodities Futures Trading Commission (CFTC) and the National Futures Association (NFA) e. Money Services Businesses (MSB): The Financial Crimes Enforcement Network (FinCEN) of the U.S. Treasury Department f. Insurance Companies: The Internal Revenue Service (IRS) of the U.S. Treasury Department g. Non-bank residential mortgage lenders and originators as loan or finance companies: The Internal Revenue Service (IRS) of the U.S. Treasury Department c) Non-Financial sector: The Internal Revenue Service (IRS) of the U.S. Treasury Department B. Thresholds for customer due diligence: Nil (basic due diligence is required for all accounts/customers regardless of transaction amounts) C. Verification requirements: At a minimum, a financial institution must obtain the following identifying information from each customer before opening an account: a) name b) address c) date of birth (for individuals) d) identification number (e.g. Taxpayer Identification Number (TIN) or passport number) The identity of the customer must be verified within a reasonable amount of time

Country	KYC applicable or not	Relevant Act	Details of applicability
			after the account is opened; however, generally the identity is verified before an account is opened. The identity is verified by either the use of document verification, or through the use of non-documentary methods (such as by comparing information provided by the customer to public databases/credit bureaus, and using third party vendors which do comparisons) or a combination of both. D. Circumstances that warrant enhanced customer due diligence measures: The USA PATRIOT Act requires financial institutions to increase their due diligence standards when dealing with foreign private banking and correspondent accounts. In addition, customers classified as high risk according to the institution's customer risk rating methodology would be subject to enhanced due diligence. Factors that would be considered in determining a customer's risk rating would include at a minimum: geography, nature of business/employment, products and services used. Local guidance also has information on products, services, customers and entities that pose higher risks and enhanced due diligence for high risk customers, such as: a) account activity that is substantially cash-intensive; b) an entity whose account activity consists primarily of questionable funds transfers, especially to/from high-risk jurisdictions; c) a business entity whose bearer shares are not under bank or trusted third party control; d) an entity that uses a wide range of bank services, particularly foreign private banking and correspondent services; e) an entity owned or controlled by off-shore, non-public business entities; or f) private investment companies or trust accounts; The KYC program should also include periodic risk based monitoring of the customer information to determine if there are any substantive changes to the original customer information. High risk customer relationships are generally reviewed annually. E. Reporting: SARs are made to the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN)

Country	KYC applicable or not	Relevant Act	Details of applicability
Germany	Yes	German Anti Money Laundering Act was created in 1993, and amended in 2003, 2008 and 2011	A. Regulator for AML controls includes: For both Banking as well as other financial services, the regulator is German Banking Supervisory Authority (BaFin). B. Thresholds for customer due diligence: No additional customer due diligence required for transactions below EUR15,000 (in total) and cash transactions in foreign coins and notes below EUR2,500. C. Verification requirements: Individuals: Evidence of identity has to be provided by documentary evidence. The physical or electronic record of the individual should contain the full name, address, date and place of birth and nationality. Documentary evidence can be a valid identity card or a passport, diplomatic passports, passport replacement papers or resident permits. Corporates that are listed in a public register: The physical or electronic record of the institute should contain firm, legal form, register number, address, domicile and names of management. Evidence of identity has to be provided by a certificate of public registration. Corporates that are not listed in a public register (partnership): The physical or electronic record of the institute should contain firm, legal form, register number, address, domicile and names of management. Evidence of identity has to be provided by a partnership agreement. In addition, the partners have to be identified like individuals. D. Circumstances that warrant enhanced customer due diligence measures: Enhanced customer due diligence is required where there is a high risk of money laundering or terrorist financing. This generally applies to transactions with Politically Exposed Persons ('PEPs') and in cases of non-face-to-face transactions. Transactions and client relationships assessed as bearing a higher money laundering/terrorist financing risk, or where the company is engaged in activities that are assessed to bear a higher money laundering risk, will require further verification and/or monitoring. For example, those clients conducting complex transactions or clients in less transparent jurisdictions. E. Reporting: SARs are made to the Criminal Investigation Department of the relevant state and to the central Criminal Investigation Department of Germany (Central Division for Suspicious Activity Reports - (Financial Intelligence Unit -FIU))

Country	KYC applicable or not	Relevant Act	Details of applicability
India	Yes	The Indian Prevention of Money Laundering Act was prepared in 2002. However, this act came into force in 2005 after the creation of the Financial Intelligence Unit (FIU) in India in November 2004.	A. Regulator for AML controls includes: FIU B. Thresholds for customer due diligence: There are requirements for banking companies, financial institutions and intermediaries to verify and maintain identification records of all its clients. Banking companies, financial institutions and intermediaries have to maintain records in respect of: a) all cash transactions of the value of more than 'rupees ten lakhs' (Rupees One Million) or its equivalent in foreign currency; b) all series of cash transactions integrally connected to each other which have been valued below 'rupees ten lakhs' (Rupees One Million) or its equivalent in foreign currency where such series of transactions have taken place within a month; c) all cash transactions where forged or counterfeit currency notes or bank notes have been used as genuine or where any forgery of a valuable security or document has taken place facilitating the transactions; d) all suspicious transactions whether or not made in cash; e) All customers who are classified as medium to high risk are subjected to DD checks but the KYC is mandatory for all clients as per RBI guidelines C. Verification requirements: The banking company, financial institution or intermediary must verify and maintain the records in respect of identity and current address of the clients. The documents required are: Individuals: Official valid documents such as passport, driving licence, Permanent Account Number (PAN) Card, Voter's Identity Card issued by the Election Commission of India or any other document. Corporate: a) Certificate of incorporation; b) Memorandum and Articles of Association; c) a resolution from the Board of Directors and power of attorney granted to its managers, officers or employees to transact on its behalf; d) an official valid document in respect of managers, officers or employees holding an attorney to transact on its behalf. Association of Persons or Body of Individuals: a) resolution of the managing body of such association or body of individuals; b) power of attorney granted to him to transact on its behalf; c) an official valid document in respect of the person holding an attorney to

Country	KYC applicable or not	Relevant Act	Details of applicability
			transact on its behalf; and d) such information as may be required by the banking company or the financial institution or the intermediary to collectively establish the legal existence of such an association or body of individuals. D. Circumstances that warrant enhanced customer due diligence measures: Customers that are likely to pose a higher than average risk to the bank may be categorised as medium or high risk depending on customer's background, nature and location of activity, country of origin, sources of funds and his client profile etc. Banks may apply enhanced due diligence measures based on the risk assessment, thereby requiring intensive 'due diligence' for higher risk customers, especially those for whom the sources of funds are not clear. Examples of customers requiring higher due diligence may include a) non-resident customers; b) high net worth individuals; c) trusts, charities, NGOs and organizations receiving donations; d) companies having a close family shareholding or beneficial ownership; e) firms with 'sleeping partners'; f) Politically Exposed Persons ('PEPs') of foreign origin; g) non-face to face customers; and h) those with a high risk reputation as per public information available etc. E. Reporting: Suspicious Transaction Reports are submitted to the FIU.

Appendix 3

Superannuation data and payment standards

Commonwealth Treasury

October 2014

1. Executive Summary

1.1 Our scope of work

Ernst & Young ('EY' or 'we') has been engaged by the Commonwealth Treasury ('Treasury') to evaluate the direct and indirect costs and benefits of selected sections of the larger portfolio of legislation developed to regulate Australia's financial systems. This engagement is a component of the current Financial Systems Inquiry (FSI), charged with reviewing all elements of legislation that impacts on the efficient operation of the complete system.

1.2 Focus of this Analysis: superannuation data and payment standards

Since 1 July 2013, regulated superannuation funds have been and are required to process requests for rollovers or transfers as soon as practical and within no less than three days ("three day rule").[42] This requirement formed part of the Commonwealth Government's SuperStream reform package, which resulted in the implementation of new e-commerce and data standards for superannuation transactions.

One of the key drivers of the SuperStream package was for transactions to be processed more efficiently and quickly, and it was the view at the time that mandatory data standards would facilitate this. Although rollover and transfers are now processed within three days, it is unclear whether the potential benefits (for instance prompter processing of transactions) outweigh the costs (for instance, superannuation funds having to hold a greater proportion of liquid assets resulting in lower returns). An analysis of the costs and benefits associated with the "three day rule" is the subject of this analysis.

1.3 Costs of the Provisions

Based on our consultation process as well as the literature review that has been conducted, we have identified the following elements as key costs of the three day rule regulatory changes:

- Private sector system implementation costs – The Commonwealth imposition of new e-commerce payment processes for rollovers required superannuation funds to develop new payment interfaces to be able to be able to generate and accept rollover data in a compliant format. We have produced a broad range estimate of these costs based on the consultation process.

- Ongoing processing costs – An aim of the SuperStream package was to deliver savings across the superannuation system by replacing inefficient paper processing with modern ecommerce practices. The consultation processes indicated that while there was potential for longer term savings the initial phase has increased processing costs for a large number of funds as the manage the additional payment interfaces. Participants also noted that, based on the complexity of the SuperStream Rollover implementation, the additional complexity inherent in the subsequent SuperStream Contribution initiative is likely to further delay the emergence of any substantial operational savings. Given the current volatility over the ongoing costs/savings profile of SuperStream we do not believe it is possible to arrive at a reliable estimate of these elements.

- Requirement to hold a greater proportion of liquid assets - In general, given the current net inflow position of the Australian superannuation system, this was not considered to me a current issue.

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[42] The allowance of a six month transition period (ended on 31 December 2013) https://www.ato.gov.au/Super/SuperStream/In-detail/What-you-need-to-know/APRA-funds/APRA-regulated-funds---the-SuperStream-standard-for-rollovers-and-contributions/

- Commonwealth implementation costs- APRA has identified a profile of additional expenditure it will incur to establish its monitoring and processing systems. The current estimate of the required future expenditure is approximately $250 million.

The table below sets out our broad range estimates for the implementation costs in 2014 dollars.

Item	Broad range of Implementation Costs	
Private sector implementation costs	$560m	$1,200m
Additional APRA Costs	$250m	$250m
Total incremental implementation costs	$810m	$1,450m

1.4 Potential benefits of the Provisions

Based on our consultation process as well as the literature review that has been conducted, we have identified the following elements as potential benefits of the three day rule:

- Additional earnings on rollover balances – Shortening the time it takes to process rollover transactions means that superannuation balances rolled over will commence earning interest at the destination fund earlier increasing the overall level of superannuation savings. We note that for paper based transactions funds effectively exit the superannuation system when a fund closes an account and issues a cheque for balance transferred. The additional earnings are not simply a reallocation of the same investment earnings pool.

- Additional interest revenue - A common comment during the consultation process was that owners of payment gateways could effectively have the use of the rollover funds held during the 3 day processing period. This may provide gateway owners with the opportunity to invest these funds while the information is exchanged between funds. We are not able to confirm whether this will apply under system implemented but have estimated the potential scale of the revenue available.

- Ongoing processing costs – As noted above the Given the current volatility over the ongoing costs/savings profile of SuperStream we do not believe it is possible to arrive at a reliable estimate of these elements.

The table below illustrates the potential scale of the annual earning/interest amounts that could be generated per day:

Item	Possible Annual Benefits per day
Additional earnings on rollover balances	$29m
Additional interest for Gateway Owners	$22m

1.5 Summary of our analysis

We would note as an initial comment that there was a reasonable consensus during the consultation process that the superannuation industry had been slow to adopt effective electronic payment protocols and that this lack of action had been a trigger for the extensive Commonwealth regulatory response. There was also general agreement that it was in the interest of superannuation stakeholders for electronic payment protocols to be adopted for all superannuation fund flows, however there was similar general agreement that the Commonwealth implementation of these protocols via the SuperStream Rollover initiative created significant cost and complexity issues for the industry.

The experience with the rollover implementation translated into similar concerns on the impacts of the following SuperStream Contributions implementation with the more complex interfaces between

employers and payroll processors considered likely to generate additional upfront and ongoing costs.

The common elements that were identified as most problematic in the development of the SuperStream requirements were:

- Specification of a payment data interface that was uncommon in the Superannuation industry
- The allocation of regulatory monitoring responsibilities between APRA and the ATO was not clear to the industry and this created confusion and added cost where funds sort to clarify regulatory requirements and deadlines
- The consultation process was did not provide sufficient time for funds to appreciate the complexity of the regulatory changes and plan implementation strategies
- The implementation timetable provided insufficient time for participants to effectively transition their legacy systems to the newly developed systems
- Volatility in the go-live dates produced a sub-optimal development and testing process for new systems

The overall market view was that the while the SuperStream initiatives will deliver substantial benefits to funds and superannuation investors, the detailed approach used by the Commonwealth in developing and applying the detailed regulatory framework has likely delayed the emergence of the long term processing efficiency benefits and introduced additional upfront costs. Adoption of a less proscriptive approach whereby the Commonwealth, based on more extensive consultation, set hard deadlines for the industry to implement efficient electronic payment standards was seen as more cost and time effective methodology.

2. Introduction

2.1 Our scope of work

We have been engaged by the Commonwealth Treasury (Treasury) to evaluate the direct and indirect costs and benefits of selected sections of the larger portfolio of legislation developed to regulate Australia's financial systems. This engagement is a component of the current Financial Systems Inquiry (FSI), charged with reviewing all elements of legislation that impacts on the efficient operation of the complete system.

2.2 Our approach

The key tasks which we undertook to complete this engagement included the following:

- A literature review of the data available on the international experience in implementing and managing legislation aimed at controlling money flows ultimately derived from criminal activity
- A consultation process with key Australian financial market participants to derive estimates of the full cost of complying with the legislation.
- Where possible review and analyses of key Australian economic and financial market data sets to produce estimates of the quantifiable benefits of the legislation
- Developed a rapid cost/benefit analysis of the legislation where the quantification of costs and benefits provides sufficient confidence that the most significant factors have been identified.
- Outline and qualitatively assess other costs and benefits for which reliable quantitative estimates cannot be developed.

2.2.1 Limitations of this Report

This Report is subject to the following limitations:

- We have relied on representations made to us by key stakeholders in the financial sector during the course of interviews and meetings. These representations have not been independently verified or validated by us
- The observations that we have made and documented in this Report are, by necessity, limited and qualified to reflect a number of factors. These include the limited time available to undertake our assessment, our terms of reference, and the reliance being placed on information provided to us which we have not been asked to independently verify
- We did not undertake any analysis to determine the appropriateness or correctness of the inputs and assumptions into this analysis
- We offer no opinion on the appropriateness or effectiveness of the financial regulation analysed in this Report.

2.3 Structure of this Report

The remainder of this report is set out as follows:

- Chapter 3 – Provides the context to the analysis performed
- Chapter 4 – Analyses the expected costs of the provisions
- Chapter 5 – Analyses the potential benefits of the provisions

3. Rollovers and transfer requirements

Summary of comments from the consultation process

There was a general opinion expressed that the overall process used to implement the SuperStream process was not particularly efficient and that as a result funds were exposed to additional costs and uncertainty over the regulatory requirements and timeframes. Key issues raised included

- The consultation process did not effectively engage with fund payment processing areas and this impeded the efficient design of the core processing requirements
- Consultation did not start early enough on the detailed mechanics of the requirements, this left funds with too little time to plan efficient system design, implementation and testing
- The regulatory obligations were imposed on transaction parties with little control over core transaction information timing and quality, this was identified as an issue with significant potential to impact on the SuperStream Contributions processing costs and efficiencies
- The Government decision to impose a new data standard on the industry not only produced inefficient cost increases but privileged other financial market institutions for new roles that the standards required. Examples given were the roles of banks as payment gateways and increased importance of payroll software houses in the SuperStream Contributions implementation
- There was a lack of clarity on the roles and responsibilities of the ATO and APRA and thus there uncertainty over the processes required to request urgent alterations to the guidelines or clarification on regulatory requirements
- The implementation deadlines were optimistic, with subsequent adjustments to provide more time not given with enough notice. Some funds commented that they had adopted system development programs sized to meet the tight deadlines, rather than optimally address the future requirements. There was not sufficient notice of the deadline extensions to enable reassessment of the development processes.

The subject of this Report is the portability rules that govern the rollover and transfer of member contributions between regulated superannuation funds. Since 1 July 2013 (regulated) superannuation funds have been and are required to process requests for rollovers or transfers as soon as practical and within no less than three days[43]. The costs and benefits associated with this regulatory requirement is the subject of this analysis.

This chapter seeks to:

- Provide an abridged background on how the three day rule for rollover and transfers
- Set out the legislative framework within which the obligations for the rollover and transfer, including the three day timeframe, are established

[43] The allowance of a six month transition period (ended on 31 December 2013) https://www.ato.gov.au/Super/SuperStream/In-detail/What-you-need-to-know/APRA-funds/APRA-regulated-funds---the-SuperStream-standard-for-rollovers-and-contributions/

- Define the objectives of the broader package of reforms (SuperStream)
- Define the three day rule for the processing of rollovers and transfers and the obligations it imposes of regulated superannuation licensees.

3.1 Background

In May 2009 the Commonwealth Government commissioned the Super System Review (the Review) to "make recommendations to ensure the superannuation system has a sharper focus on operating in members' best interest". The final report was handed down on 30 June 2010.

The Review identified a number of back office inefficiencies in superannuation system, including (but not limited to) the use of paper forms that contributed to poor data quality and resulted in processing delays (as well as duplicate and lost accounts) which added to costs.

To address these inefficiencies, one of the key elements of suggested reform included in the Review was "making the process of everyday transactions easier, cheaper and faster through the SuperStream package of measures."[44] This included the recommendation to implement common data standards and forms to allow for electronic transactions within the superannuation system. Subsequent consultation by the Commonwealth Government also highlighted that "to achieve the necessary improvements in data quality there was a need to mandate the use of data and payment standards across all superannuation transactions involving member contributions and rollovers."[45] Informed by industry submissions to the Review, the Commonwealth Government anticipated that savings up to $1 billion per year were achievable from implementing the SuperStream reforms."[46]

In response, the Commonwealth Government made the necessary legislative and regulatory changes to mandate the use of the data and payment standards for superannuation transactions, including rollover and transfers. The Data and Payment Standard introduced a streamlined method for sending superannuation payments and associated information electronically, using tax file numbers as the primary account identifier.

The use of SuperStream was made (and is) mandatory for all employers making superannuation contributions, and all regulated superannuation funds and self-managed superannuation funds that receive contributions.[47] As part of these reforms, and as required by regulation, from 1 July 2013 superannuation funds must process rollovers and transfer requests as soon as practical within no more than three days.[48]

3.1.1 Legislative framework

The framework governing the Australian superannuation system is comprised of legislation and associated regulations, subordinate legislative instruments and additional guidance material. A brief description of each of these elements and their relationship to rules on processing transfer and rollover requests, and the role of the regulator is discussed below.

- *Superannuation Industry (Supervision) Act 1993* (SIS Act) – the SIS Act and associated regulations set out the circumstances in which a registered superannuation entity (RSE)

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[44] Australian Government, Stronger Super, Information Pack, 21 September 2011
[45] Australian Government, Stronger Super, Information Pack, 21 September 2011
[46] Australian Government, Stronger Super, Information Pack, 21 September 2011
[47] https://www.ato.gov.au/Super/SuperStream/In-detail/Contributions/Employer-FAQs-Getting-ready-for-SuperStream/
[48] The allowance of a six month transition period (ended on 31 December 2013) https://www.ato.gov.au/Super/SuperStream/In-detail/What-you-need-to-know/APRA-funds/APRA-regulated-funds---the-SuperStream-standard-for-rollovers-and-contributions/

licensee may or must pay a member's benefit from a RSE[49]

- *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) – regulation 6.34A stipulates the timeframes within which requests for rollovers and transfers must occur (i.e. no later than three days)[50]

- *Superannuation Data and Payment Standard 2012* (the Standard) – a legislative instrument (for the purpose of the *Legislative Instruments Act 2003*) that "specifies the minimum requirements for dealing with payments and information relating to certain transactions within the superannuation system including… rollovers, transfers between superannuation entities and associated reporting obligations for superannuation purposes"[51]

- *Prudential Practice Guide SPG 280 – Payment Standards, November 2013* (PPG) – provides guidance on APRA's views of sound practice, but do not themselves create legally enforceable requirements. The PPG "aims to assist an RSE licensee in complying with the requirements of the SIS Act and Part 6 (payment standard) of the SIS Regulations, the superannuation data and payment regulations and standards and, more generally, to outline prudent practices in relation to paying benefits."

The SIS Act, SIS Regulations and Standard also set out the requirements for common data standards and processing requirements for benefit payments paid as rollovers or transfers.[52]

- Australian Prudential Regulation Authority (APRA) – supervises regulated superannuation funds (other than self-managed superannuation funds which are overseen by the Australian Tax Office), Approved Deposit Funds, and Pooled Superannuation Trusts (all of which are regulated by the SIS Act).[53]

3.1.2 Objectives

As discussed (3.1 refers) SuperStream was implemented to address back office processing inefficiencies by introducing a new data and e-commerce standards for superannuation transactions and allowing the use of tax file numbers as the primary locator of member accounts. SuperStream sought to:

- Improve the quality of data in the system

- Encourage the use of technology to improve processing efficiency

- Improve the way fund to fund rollovers are processed and the way contributions are made.[54]

In summary, by providing an electronic method of transacting liked data and payments, including for rollover and transfers, SuperStream intended to improve the efficiency and productivity of the superannuation system by reducing the time and effort taken to process rollover and contributions.

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[49] Section 31(2)(i) of the SIS Act allows for regulations to prescribe operating standards for regulated superannuation funds in regards to "the portability of benefits arising directly or indirectly from amounts contributed to the fund" and subsection 34K(3) allows for the Superannuation Data and Payment Standards 2012

[50] "Superannuation system", "rolled over" and "transferred" are defined in regulation 5.01 of the SIS Regulations

[51] Australian Government, Superannuation Data and Payment Standards 2012, Explanatory Statement

[52] Superannuation data and payment standard as defined in section 10 of the SIS Act

[53] http://www.apra.gov.au/Super/Pages/default.aspx

[54] Australian Government, Stronger Super, Information Pack, 21 September 2011

3.2 Rollover and transfer processing obligations (three day rule)

From 1 July 2013, superannuation licensees were required to process rollovers and transfers as soon as practicable and within no more than three days (assuming all the mandatory information has been received).

APRA's PPG sets out further guidance on the rules around the portability of members' contributions which superannuation trustees must adhere to. Paragraph five states:

> *An RSE licencee is responsible for ensuring that each benefit payment is processed in a way that is compliant with the requirements of the SIS Act, the SIS Regulations, the Standards (for rollover and transfers), the governing rules for the RSE and any other requirements for the payment of benefits... An RSE licensee is also responsible for managing risks associated with the processing of a benefit payment.*

In the PPG, APRA suggests that prudent licensee will:

- Establish, monitor and review policies and procedures regarding the acceptance, identification and processing of applications to pay, transfer or rollover benefits. This includes measures to be taken in the instance of a breach e.g. procedures for rectification, identifying which parties are to be notified (e.g. member, receiving RSE, paying institution, Board or Board committee, regulators) and disclosure to members[55]
- Consider the potential cash flow and liquidity risks attributed to processing and paying benefits within three days and address these risks in its risk management frameworks
- Factor any impact of this three day rule into their asset allocation, cash flow planning and liquidity requirements.

[55] http://www.apra.gov.au/Super/Documents/Prudential-Practice-Guide-SPG-280-Payment-Standards.pdf

4. Identified Costs of the Regulatory Framework

4.1 Potential Costs

The impact of the potential costs amassed to society can be grouped into the following categories: tax payers, superannuation fund licensees, superannuation fund members and economy wide.

Based on our consultation process and literature review, the following costs have been identified as potentially significant:

Cost	Stakeholder	Measurement / required data
4.1.1 Increase in liquid assets held meet three day processing rule for rollover and transfers	Superannuation funds (ultimately members through additional administrative costs)	Qualitative only
4.1.2 Development and management of systems and procedures to ensure requirements of the three day rule are met	Superannuation funds	Once off system costs incurred by funds
4.1.3 Additional processing costs	Superannuation funds	Qualitative only
4.1.4 Investigation, enforcement and monitoring of non-compliance	Tax payer (APRA)	Budget Papers, Annual Reports

4.1.1 Increased requirement to hold liquid assets

In general funds commented that because of the continuing high net inflow of funds into the Superannuation system the 3 day rollover requirement would be unlikely to have an appreciable immediate impact on investment strategy. It was agreed that this issue could become of concern as the Australian system moves from inflow to outflow status over the longer term.

A number of more mature funds that are currently approaching net benefit payments were reassessing the impact of the rollover requirement with one projecting it would need to reduce its holding of illiquid investments by 20% to provide an appropriate buffer.

We are of the view that this issue should be monitored by the Commonwealth so that the regulations can be adjusted if there are clear, sustained negative impacts on investment earnings triggered by additional liquidity requirement impacts on investment strategies.

4.1.2 Development and management of internal policies and procedures

The consultation process highlighted significant variance in the implementation costs attributable to the rollover requirements. This could be expected given the wide differentials in the progress of individual funds in independently implementing electronic payment processing systems. Estimates provided indicated a range of 0.03% to 0.065% of fund assets as a potential benchmark of the cost of implementing the rollover requirements. This equates to a total industry cost of between $560m and $1.2b based on current estimates of fund asset holdings of $1,850b[56].

An additional issue that did drive additional costs was that the highly proscriptive approach adopted by Commonwealth in specifying payment data requirements and formats meant that funds that had already made significant investment in developing electronic payment systems had to re-engineer their systems to comply with the new standards. In some cases this forced the creation of largely

[56] RBA Assets of financial institutions October 2014

redundant additional data interfaces to translate the internally developed data format into the Commonwealth mandated structure.

4.1.3 Additional processing costs

Generally funds reported minimal current processing savings from the rollover initiative. A number indicated that the short term costs were higher as the compliance and processing protocols were bedded down and dual paper and electronic modes were processed. There was a common view that the implementation of the SuperStream Contribution initiative would potentially impose proportionately higher initial processing costs because of the substantially more complex interface between the superannuation industry and employers.

There was the general expectation that the savings mentioned in the 2010 Cooper Review would still be achievable in the longer term but that it is currently difficult to project when the initial cost imposts would tail off and savings start to emerge. For this reason we believe it is too early to develop estimates of the ongoing annual processing cost impacts.

4.1.4 Investigation, enforcement and monitoring of non-compliance

APRA has produced internal estimates of its costs in developing the systems needed to monitor and manage industry compliance with the overall SuperStream system. The current estimate detailed in their budgetary statements for the 2014-2018 financial years is $250m.

4.2 Summary of costs

The market estimated costs of implementing the SuperStream Rollover provisions were significant with a consistent view that the Commonwealth approach did generate additional costs. At a conceptual level the issue was primarily around the Commonwealth choosing to proscriptively define data requirements and standards. The fact that the standard chosen was not common in the superannuation industry created additional upfront design and analysis task for participants and forced funds with advanced electronic payment projects to develop additional interface layers.

It was acknowledged that the slow progress of the industry in reforming payment processing was a factor in the Commonwealth adopting a more interventionist approach in its implementation of the overall SuperStream reforms. Overall industry was still of the view that a more risk based approach, where the Commonwealth set the deadlines for adoption of electronic payment methods and provided a default payment clearing house for smaller funds, with the industry required to develop data requirement and format standards would have produced a more cost and time efficient implementation process.

We do not believe it is appropriate to develop estimates of the likely industry long term processing costs/saving profile at the current point. It too early in the system lifecycle to determine the eventual level and timing of efficiencies which may emerge from the move to an electronic payment system. Fund operational expenses should be monitored in respect of the SuperStream framework to identify if there are any particular aspects that are preventing the Industry realise substantial processing savings.

5. Benefits of the Provisions

5.1 Potential Benefits

The impact of the potential benefits accrued to society can be grouped into the following categories: tax payers, superannuation fund licensees, superannuation fund members and economy wide.

Based on our consultation process as well as a literature review, the following benefits have been identified and reviewed:

Benefit	Stakeholder	Measurement / required data
5.1.1 Additional superannuation investment earnings	Superannuation members	System rollover values Estimates of rollover time improvements
5.1.1 Additional interest earnings	Payment gateway owners	System rollover values Estimates of rollover time improvements
5.1.2 Improved fund administration and reduced time taken to validate members and process rollover requests (productivity improvements)	Superannuation funds (ultimately passed on to members)[57]	Qualitative

NOTE: The 2010 Cooper Review estimated that SuperStream could generate an additional retirement income of $40,000 to $45,000

5.1.1 Additional investment earnings

Estimates of the pre-SuperStream average rollover processing timeframes were between 10-20 days so that moving to a 3 day period would potentially allow fund investors to earn between an additional 7-17 days investment earnings. The level of rollovers is naturally highly volatile, depending on member preferences and the relative performance of individual funds, so that projecting long term annual additional earnings is extremely difficult.

As an estimate of the scale of the potential benefits, we have reviewed the accounts of a number of larger funds for the 2013 financial year and calculated that the average % inward rollovers represent of the fund assets was close to 10%. Applying an earning rate of 6%[58] to 10% of the current estimate superannuation system assets of $1,850b would indicate additional earnings potential of $29m per day processing saved over a year. Naturally the year to year benefits will depend on the actual level of rollovers and transfers occurring in the market

5.1.2 Additional interest earnings

If the payment gateway owners control the rollover funds during the assumed three day processing period they will be the beneficiaries of the any additional short term interest earnings that can be generated . Using the same approach as for the benefits under 5.1.1 but using an the ten year average of the overnight cash rate of 4.62%[59] produces an estimate of $22m per annum for each day gateways have the benefit of the rollover funds.

[57] Other fund members will also benefit from the extended use of member TFNs through the potential for reduced multiple accounts which means members no longer need to pay administration fees on multiple accounts; and the potential for fewer lost superannuation accounts.

[58] APRA June 2013 Superannuation Statistics

[59] RBA interest data series

5.1.3 Rollover and transfer requests productivity improvements

There was the general expectation that the savings mentioned in the 2010 Cooper Review would still be achievable in the longer term but that it is currently difficult to project when the initial cost imposts would tail off and savings start to emerge. For this reason we believe it is too early to develop estimates of the ongoing annual processing cost impacts.

5.2 Summary of Benefits

All participants recognised that the end state of the SuperStream reforms will be a win-win situation for funds and fund members. There was also common agreement that the processing cost efficiencies and additional investment earnings will be the key quantifiable benefits. The most active discussion was on how long it will take for the SuperStream reforms to fully integrated into system processing and thus how long it will be before the processing cost efficiencies are generated. A number of funds noted fully realising the potential savings would require further capital expenditure beyond that required for simple compliance and that this would be subject to internal cost/benefit analysis.

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