WELLBEING, RESILIENCE AND PROSPERITY FOR AUSTRALIA

FINANCIAL SYSTEM INQUIRY

Final Submission
August 2014

CommonwealthBank

WE ALL HAVE A RESPONSIBILITY TO INVEST IN SOLUTIONS THAT ADDRESS THE BROAD NATIONAL INTEREST.

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PROACTIVE AND PRINCIPLES-BASED REGULATION IS THE MOST EFFECTIVE WAY TO ENSURE THE STABILITY OF THE AUSTRALIAN FINANCIAL SYSTEM.

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EXECUTIVE SUMMARY

Australia has a strong and prosperous future, which will be underpinned by an efficient, stable, secure, adaptable and resilient financial system.

The Commonwealth Bank of Australia Group (Commonwealth Bank) welcomes the opportunity of the *Financial System Inquiry* (FSI) to engage in timely consideration of policy, regulation and practice reform necessary for the continued growth of the Australian economy and its global role, and the opportunities this creates for individuals, businesses and communities to achieve their goals.

In this process, all stakeholders have a responsibility to invest in solutions that address the broad national interest. Government has a vital role to play in delivering a regulatory and policy framework to deliver these goals, and enable investors and enterprise to back their ideas, and secure their own prosperity. System participants must recognise their position as critical enablers of economic and social wellbeing.

Commonwealth Bank was pleased to submit its initial recommendations – '*Wellbeing, Resilience and Prosperity for Australia: Financial System Inquiry' (First Submission)* – to the Inquiry in March 2014, and now provides this response to the July 2014 *Financial System Inquiry Interim Report (Interim Report)*. This submission is a companion document to Commonwealth Bank's *First Submission*; the two should be read together.

The Inquiry's *Interim Report* has provided thoughtful and constructive observations and policy options, through the lenses of Australia's productivity growth, consumer security, and the responsiveness of the superannuation system to the needs of Australians.

Many observations in the *Interim Report* such as the priority of customer wellbeing and system resilience in competition, funding, stability, superannuation and technology positively reflect Commonwealth Bank's views.

Commonwealth Bank endorses the high level assessment that:

> *'the Inquiry has not seen evidence to suggest a need to reform radically the way Government intervenes in or regulates the financial system',*[1] *and that it 'has performed reasonably well in meeting the financial needs of Australians and facilitating productivity and economic growth'.*[2]

1 Australian Government – Financial System Inquiry (2014) Financial System Inquiry Interim Report, July 2014, page 1-3. (*Interim Report*)

2 Ibid, page 1-7.

Australia has much to be proud of in its Global Financial Crisis (GFC) and post-GFC experience. Australia benefitted from sound regulatory settings, ongoing competition and international integration reforms that helped it avoid the collapses experienced in other developed economies. The Australian post-GFC settings must promote innovation and prepare for the future, because whatever challenges the industry inevitably faces will likely arise from causes that may not have been anticipated.

A post-GFC reform response must also enable and promote evidence-based decision making, supported by a framework that confidently uses Australia's long-standing responsible prudential behaviour as a competitive advantage, in a heavily competitive global market.

Commonwealth Bank advocates an active supervisory model, underpinned by principles-based regulation and focussed on strong corporate governance, prudent risk culture and real customer outcomes, to significantly reduce the risk that any firm will encounter financial difficulties or lead to delivery of adverse outcomes for consumers.

Meanwhile, boosting the financial literacy and confidence of Australia's citizens and customers will, over time, reduce the regulatory imperatives of government on its finance system.

Commonwealth Bank advocates these positions drawing on its unique heritage over more than a century and on behalf of its Australian-based shareholders, comprising nearly 800,000 households who own Commonwealth Bank shares directly and millions more who own them through their pension funds.

Commonwealth Bank is confident the information and proposals this submission provides are consistent with the Australian Government's objectives to grow the economy, make its markets freer, accelerate investment in productive infrastructure, and build resilience to future economic shocks, wherever they may emerge.

The information and proposals also strengthen Australia's capacity to put downward pressure on the cost of living and build choice, opportunity and sustainability in incomes for an ageing population.

Key recommendations include:

- Increasing the emphasis on building and enhancing forward looking and adequately resourced financial sector supervisory models;
- Promoting a combination of higher education standards for financial advisers and technology-neutral regulatory environments to stimulate affordable, accessible and appropriate financial information;
- Providing time to allow the realisation of measures to reduce fees in the superannuation system to contribute to greater retirement security and reduce pressure on the Age Pension;
- Improving lender access to publicly-held information about small to medium enterprises to facilitate business lending;
- Enabling the Australian Prudential Regulatory Authority (APRA) to approve Internal Ratings Based (IRB) accreditation to non-major banks for a portion of their credit portfolios such as housing loans to improve choice and competition for home loan seekers;
- Agreeing that Australian banks will only report internationally comparable capital ratios. This will enable a consistent understanding of the strong capital positions of the Australian banks to ensure continued access to global capital markets, including through periods of stress;
- Continuing the strong supervisory approach of APRA, including ensuring that the conservative settings around capital required by APRA remain, and can be applied at a bank-specific level through a Pillar 2 adjustment, without confusing the reporting of capital ratios to the market;
- Using APRA-designed stress tests to determine the level of loss absorbing capital that Australian banks should hold. This protects taxpayers from the risk of banks failing by ensuring that all parts of the financial system are focused on worst-case scenarios, not just current economic conditions, in determining capital levels. Nevertheless, stress-tests should take into account the unique composition of the Australian banks' portfolios with high levels of loan-based banking businesses, which result in slower loss emergence and a longer timeframe in which to address issues; and
- To the extent that stress tests may require more loss absorbing capacity than exists today, thinking beyond Common Equity Tier 1 capital (CET1) or broad bail-in powers to strengthen loss absorbency. This will strike the right balance between loss absorbing capacity and on-going funding costs and capacity. For example, 'Tier 3 capital' may be a very efficient instrument for striking this balance.

In some areas, Commonwealth Bank has a different perspective on the observations made by the Inquiry. In such cases, it offers alternate evidence-based proposals for consideration. These proposals will contribute to the Inquiry's interest that interventions, if and where they must occur, balance efficiency, stability and fairness.

Commonwealth Bank encourages the Inquiry to make recommendations that address the broad national interest, with the belief that the settings that underpin a strong, sustainable and growing economy will also serve its customers, shareholders and all Australians well.

The Inquiry Chairman made the point *'that Australians and their national interest will prevail if we balance individual interests and the public good in the design of the financial system'.*[3]

Commonwealth Bank makes recommendations in this spirit, and consistent with its vision for the future of Australia and the financial system. Commonwealth Bank thanks the Inquiry for its work and the opportunity to contribute.

3 Murray AO, David (2014) "Sustaining confidence in the Australian financial system", Speech to the National Press Club by Mr David Murray AO, Chairman of the Financial System Inquiry, 15 July 2014. Accessible online at http://fsi.gov.au/2014/07/15/speech-to-the-national-press-club/

THE SETTINGS THAT UNDERPIN A STRONG, SUSTAINABLE AND GROWING ECONOMY WILL ALSO SERVE OUR CUSTOMERS, SHAREHOLDERS AND ALL AUSTRALIANS WELL. COMMBANK CAN.

SECTION 1: CONTRIBUTING TO A STRONG FUTURE FOR AUSTRALIANS

Wellbeing, Prosperity, Resilience.

> ‘Projections for growth in superannuation assets in Australia emphasise the significance of this sector to the overall system, hence our focus on superannuation in the Interim Report.’
> – David Murray AO, Chairman, FSI[4]

The Inquiry expressed interest in *‘whether end users can have trust and confidence in the system’*.[5]

Commonwealth Bank supports efforts that strengthen and, where appropriate, adjust the regulatory framework to enhance trust and confidence in the system.

This section outlines views and recommendations to strengthen the superannuation system to meet emerging challenges, and measures to improve the customer experience and outcomes for customers in their diverse interactions with the financial system.

Commonwealth Bank favours the adoption of principles that ensure reforms to the regulatory system endeavour to prevent compliance failures through supervision rather than reactive measures that address breaches that have already occurred. Commonwealth Bank further recommends that reform efforts be designed to provide optimal financial security in retirement and address cost of living pressures.

The Inquiry’s observation[6] that improved financial literacy is not a panacea for the issues it seeks to address is endorsed. However, it is an important pillar which will be outlined in proposals in this section.

4 Murray AO, David, op. cit.
5 Murray AO, David, op. cit.
6 *Interim Report*, page 3-60.

CHAPTER 1: SECURITY IN RETIREMENT

In the next 10 years, Australia will have an older population supported by a smaller proportion of people of working age. Sufficiency of savings and the Age Pension will be critical to address the retirement needs of people as they live longer.

The achievement of a secure retirement for each individual depends on the quality of decisions made throughout his or her life, and how the accumulation phase is managed. From the start of their working lives, people should be equipped with a clear idea of the annual amount of money they need in retirement, and how to achieve this. They should have access to choices and products that give them confidence that they can achieve their retirement goals without undue anxiety or financial stress.

This chapter addresses the panel's observations, suggested policy options and information requests on the objectives of the superannuation system; the characteristics and trends in the superannuation industry; specific issues related to superannuation investments; potential enhancements for the retirement landscape; and system efficiency.

1. OBJECTIVES OF THE SUPERANNUATION SYSTEM

The Chairman of the Inquiry observed *'a lack of 'shared philosophy' and set of objectives for superannuation'.*[7] Commonwealth Bank acknowledges the Chairman's observation. However, while a shared philosophy is not specifically articulated, Commonwealth Bank believes the underlying objectives of the system are represented by the following: [8]

1.1 Provide an adequate level of retirement income

The superannuation industry is committed to providing adequate retirement income streams for members. Progress is being made with over 80% of superannuation benefits currently paid as income streams. This can be expected to increase as average balances increase. In defining an 'adequate' level of income, Commonwealth Bank supports the Association of Superannuation Funds of Australia's (ASFA) benchmark 'comfortable' level of income for most Australians ($58,128 per annum for a couple), and a target replacement rate for high income earners (e.g. 65%).[9]

1.2 Relieve pressure on the age pension

There is evidence of progress towards superannuation savings reducing the pressure on the Age Pension. In its initial submission to the Inquiry, the Financial Services Council (FSC) cited research from the National Centre for Social and Economic Modelling (NATSEM) which found that budget savings in 2013-14 related to the Age Pension from the superannuation system totalled $5.7 billion,[10] with savings increasing to $11.1 billion in 2030.[11]

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7 Murray AO, David, op. cit.

8 Australian Government–Superannuation Charter Group (2013) A Super Charter: Fewer Changes, Better Outcomes – A report to the Treasurer and Minister Assisting for Financial Services and Superannuation, July 2013, Chapter 4. Accessible online at http://www.treasury.gov.au/Policy-Topics/SuperannuationAndRetirement/supercharter

9 The Association of Superannuation Funds of Australia Limited (2013) Super system evolution: Achieving consensus through a shared vision, ASFA White Paper, May 2013, page 5. Accessible online at http://www.superannuation.asn.au/ArticleDocuments/1189/ASFA_WhitePaper_May2013.pdf.aspx

10 University of Canberra—National Centre for Social and Economic Modelling (NATSEM) (2014) Increasing Superannuation Contributions for future health and aged care needs, Report prepared for the FSC, 11 March 2014, page 6. Accessible online at http://www.fsc.org.au/downloads/file/policy/FSCNATSEMReport280314.pdf

11 Financial Services Council (2014) "Financial System Inquiry submission: Federal Budget Sustainability (Chapter 4)", page 6. Accessible online at http://www.fsc.org.au/downloads/file/policy/FSCFSICH4FedBudgetSustainabilityAPR14.pdf


FROM THE START OF THEIR WORKING LIVES, PEOPLE SHOULD BE EQUIPPED WITH A CLEAR IDEA OF THE ANNUAL AMOUNT OF MONEY THEY WILL NEED IN RETIREMENT AND HOW TO ACHIEVE THIS.
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The 2010 Intergenerational Report[12] highlighted the costs of Australia's ageing population. In particular, age pension-related payments are projected to increase from 2.7% of GDP in 2009–2010 to 3.9% by 2049–2050. Although this is relatively low by international standards,[13] it still presents policy and fiscal challenges for Australia.

1.3 Increase national savings, creating a pool of patient capital to be invested as decided by fiduciary trustees

Total superannuation assets are now $1.85 trillion.[14] Approximately 79% of these assets are invested domestically representing a significant pool of funds in the economy.[15]

National savings in Australia have trended higher since the introduction of the superannuation guarantee and the savings ratio has increased substantially in the last decade, from 0.3% of income in 2003 to 10.5% in 2013.[16] Commonwealth Bank agrees with the FSC's observations that *"From a macroeconomic perspective, the benefit to the Australian economy of this stable growth in national savings in a manner that is resilient to international shocks cannot be understated. When compared to the impact on national savings of the 1990–92 recession, the global financial crisis and the Asian financial crisis were relatively modest."*[17]

2. CHARACTERISTICS OF THE SUPERANNUATION SYSTEM AND TRENDS IN THE INDUSTRY

The Australian superannuation system can be characterised as a privately funded defined contribution savings system. It relies on mandatory employer-funded contributions and members' tax-incentivised voluntary contributions. Strict preservation requirements ensure that superannuation savings generally cannot be withdrawn before individuals reach retirement.

However, the trends in the industry indicate these characteristics will change:

- Relatively low average balances (and therefore small retirement balances) are likely to increase in size over time. The take up of income streams instead of lump sums in retirement will increase based on observed consumer behaviours;[18]
- The system, which is currently weighted towards the accumulation phase with higher allocation to growth assets, will likely change to a more conservative asset allocation as it matures;[19] and
- Increasing fund size, increased competition in the award default fund market, implementation of the Stronger Super regulatory reforms, including MySuper, as well as the expected change in investment mix are expected to continue to drive down superannuation fees over the longer term.[20]

Commonwealth Bank acknowledges the Inquiry's observation that *"Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system".*[21]

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12 Australian Government—Treasury (2010) Australia to 2050: future challenges, January 2010, Chapter 4. Accessible online at http://archive.treasury.gov.au/igr/igr2010/report/pdf/IGR_2010.pdf
13 ibid, page 61.
14 This figure is current as at the end of the June 2014 quarter. See Australian Government—Australian Prudential Regulation Authority (2014) Statistics: Quarterly Superannuation Performance (June 2014 interim edition issued on 21 August 2014), page 6. Accessible online at http://www.apra.gov.au/Super/Publications/Pages/quarterly-superannuation-performance.aspx
15 Financial Services Council (2014) Financial System Inquiry: Chapter One: Superannuation, Submission to the Financial System Inquiry, February 2014, page 7. Accessible online at http://www.fsc.org.au/downloads/file/policy/FSCFSICH1SuperannuationChapter.pdf
16 ibid, page 5.
17 ibid, page 5.
18 Rothman, G. and Wang, H. (2013) 'Retirement Income Decisions: Take-Up and Use of Australian Lump Sum and income Streams', paper presented at the 21st Colloquium of Superannuation Researchers, Sydney, 9 and 10 July 2013.
19 Colonial First State superannuation and account based pension product data; *Interim Report*, page 2-85; Rice Warner (2014) Ageing and Capital Flows 2014 (for Financial System Inquiry), Report commissioned by Institute of Actuaries, page 35. Accessible online at http://www.actuaries.asn.au/Library/Reports/2014/AgeingandCapitalFlows.pdf
20 Rice Warner (2014) FSC Superannuation Fees Report 2013, May 2014, pages 6, 10 & 14. Accessible online at http://ricewarner.com/media/96729/Rpt-FSC-Superannuation-Fees-Report-2013-FINAL.pdf; Rice Warner (2014) Ageing and Capital Flows 2014 (for Financial System Inquiry), page 35; Colonial First State superannuation and account based pension product data.
21 *Interim Report*, pages 1-9, 2-95, and 2-118.

Further, Commonwealth Bank agrees that stability is vital to achieve customer confidence, and that system enhancements must not ‘move the goalposts’ and compromise its objectives.

Meanwhile, it is important that recent regulatory changes are given adequate opportunity to take effect to ensure that future policy and regulation consider the current state of system.

The recommendations in this *Final Submission* help to facilitate the effective evolution of the system while maintaining stability and confidence in the current settings.

3. ADDRESSING ISSUES RELATED TO SUPERANNUATION INVESTMENTS

Commonwealth Bank believes the superannuation accumulation phase is now relatively well understood and working well. However, there are improvements to be made to maximise the opportunities and outcomes for individuals during the accumulation phase.

The *Interim Report* raised issues relating to superannuation investments. Commonwealth Bank has responded to the Inquiry’s invitation for views or more information on policy options. These are discussed below.

3.1 Superannuation asset allocation

The Inquiry stated that Australian funds hold more growth assets compared to those in other countries.[22] Growth assets, while carrying greater risk, are generally expected to produce higher returns than more conservative assets over the longer term. As investment objectives change, an asset allocation can change between growth and more conservative assets. Growth assets are typically thought to be appropriate for people with longer investment time horizons.

The superannuation sector in aggregate allocates approximately 50% to equities, 25% to fixed interest, and 25% to other asset classes (including property/infrastructure assets).[23] While meaningful international comparisons are extremely difficult given the idiosyncrasies and maturity of each system, jurisdictions including the US, Chile and the UK have a similar allocation towards equities as Australia, in the range of 40% to 50% of allocation.[24]

Commonwealth Bank believes that the current allocation profile is broadly appropriate given structural factors including:

- The dominance of defined contribution funds, where individuals bear investment risks and returns, and trustees are focused on maximising wealth for members;
- The fact that a majority (~80%) of total fund assets are still held in the accumulation phase, and many workers have not been saving for their entire working life given the introduction of superannuation guarantee contributions in 1992; and
- A dividend imputation system, which increases the relative attractiveness of Australian equities as investors receive refunds relating to the level of corporate taxation paid on most dividends.

Australia has a relatively low allocation (25%) to fixed income, compared to other countries, e.g. Hong Kong (35%), US (40%), UK (45%), and Chile (45%).[25] As the superannuation system matures and the baby boomer generation ages, allocation to fixed income may need to increase in order to minimise sequencing risks.

22 *Interim Report*, page 2-101.
23 Mercer (2014) Asset Allocation of Pension Funds around the World, Report prepared for the Financial Services Council, February 2014. Accessible online at http://www.fsc.org.au/downloads/file/ResearchReportsFile/MercerResearch.pdf
24 ibid.
25 ibid.

3.2 Superannuation portability and liquidity

The Inquiry has sought views on lengthening the three day portability rule and allowing a staged transfer of members' balance between funds.[26] The Inquiry notes that the superannuation portability requirements may result in the sector holding more liquid assets than it needs.[27]

Choice should be the foundation of the superannuation system, particularly given the compulsory nature of savings held within the system. As such, portability should remain a key attribute of the system. Portability provides members with greater flexibility in consolidating their benefits or diversifying risk over a number of superannuation providers. Portability also supports competition by encouraging consolidation, which can help put downward pressure on costs.

There are already regulatory mechanisms in place during periods of market stress to manage superannuation portability and liquidity. APRA can suspend or vary members' rollover entitlements of its own accord or on request from a trustee if it believes that meeting the rollover request would impact negatively on the fund's financial position, or on the interests of other members of the fund.[28]

The Super System (Cooper) Review Final Report concluded that changes to benefit portability arrangements, such as increasing the portability requirements to 90 days or longer, are unlikely to have any effect on superannuation funds investing in illiquid investments such as infrastructure given the challenges of liquidating infrastructure assets quickly.[29]

The Inquiry also noted that superannuation is an important source of funding for long-term capital formation,[30] which provides opportunities for investment in productive infrastructure.

The Commonwealth Bank believes that, in the interests of promoting choice and competition, the superannuation and portability settings should not change. Commonwealth Bank also recommends that further discussion should be facilitated with the aim of encouraging long term investing.

RECOMMENDATION

Current portability settings should be retained and the Government is encouraged to investigate other mechanisms to encourage allocation to illiquid investments.

26 *Interim Report*, pages xxiv and 2-114.
27 *Interim Report*, page 2-111.
28 Regulations 6.36 and 6.37 of the Superannuation Industry (Supervision) Regulations 1994 as amended by Regulations 6.36 & 6.37 of the Superannuation Industry (Supervision) Amendment Regulations 2003 (No.4) 2003 No.196.
29 Australian Government (2010) Super System Review Final Report—Part Two: Recommendation Packages, Chapter 6 Section 5.2.2, page 184. Accessible online at http://www.supersystemreview.gov.au/content/content.aspx?doc=html/final_report.htm
30 *Interim Report*, page 2-95.

3.3 Active investment management

Many funds actively manage superannuation assets in the pursuit of higher returns. Grattan Institute research cited by the Inquiry concludes *"active management of superannuation assets increases costs but not after-fee average returns in the sector".*[31]

Commonwealth Bank does not endorse this view, believing that good active investment management can add significant value for members, as well as ensuring pricing efficiency and lowering transaction costs.

There is much academic research on the merits of active versus passive asset management. There is evidence that some active management adds value for investors. Mercer data shows the average rolling 5 year excess return for the median Australian share manager was +1.5% p.a. (gross of fees) for the 15 year period to 30 June 2014.[32]

An active investment approach and rigorous research can identify value and exploit inefficiencies in markets and provide an efficient allocation of capital. Mispricing of securities has an adverse impact on the allocation of capital and produces uneconomical outcomes for businesses and their employees. Active investment managers should also provide important feedback to the market on governance and sustainability issues. This combination of factors means active investment activities can produce positive benefits for the market and economy.

In order to promote an efficient superannuation system, it is necessary to have an open market where both passive and active investment management compete. Commonwealth Bank advocates that the principle of choice, exercised by increasingly confident and knowledgeable customers, should underpin superannuation policy settings.

RECOMMENDATION

Trustees should continue to have the flexibility to develop their own investment strategies incorporating active investment management on a competitive basis and in members' best interests, without prescription.

3.4 Short-termism

Given the long-term investment horizon of superannuation funds, the Inquiry queried whether there is an undue focus on short-term returns by superannuation funds.[33]

Commonwealth Bank is concerned that there is an inappropriate focus on short-term performance. The prevalence of investment performance reporting on a short-term basis (less than 12 months) is counterintuitive to the long-term objectives of the superannuation system. Excessive focus on the short-term can also result in high levels of portfolio turnover and associated transaction costs and fees, while reducing the length of time investments in companies are held.

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31 Minifie, J., Cameron, T., and Savage, J. (2014) Super sting: how to stop Australians paying too much for superannuation, Grattan Institute, Victoria, April 2014. Accessible online at http://grattan.edu.au/wp-content/uploads/2014/05/811-super-sting.pdf; Interim Report, page 2-109.

32 CFSGAM analysis of Mercer Australian Share (Long Onlly) Manager Universe. Note: actively managed Australian share wholesale unit trusts median fees range between 0.57% ($200 million) and 0.68% ($25 million) according to Mercer's Global Asset Management Fee Survey 2012.

33 *Interim Report*, page 2-115.

One example of international efforts to shift this focus is the Investment Leaders Group established by the University of Cambridge in 2013, which has the objective of promoting responsible, long-term, sustainable value creation in investment management. Commonwealth Bank's Colonial First State Global Asset Management (CFSGAM) is leading a work stream on 'long-term, sustainable investment mandates', which specifically considers the roles of benchmarking, high frequency trading, investment mandates and performance reporting in achieving the objective.

As part of recent regulatory reforms to enhance fund data reporting and develop greater transparency and comparability of superannuation products, APRA will soon begin reporting MySuper fund performance on a quarterly basis. Commonwealth Bank supports transparency measures which facilitate a long term investment horizon.

RECOMMENDATION

The Inquiry should review the international research on short-termism and determine its relevance to the Australian system. APRA's enhanced superannuation reporting framework should have regard to the long term nature of superannuation investments.

4. ENHANCING THE RETIREMENT LANDSCAPE

Commonwealth Bank shares the views of the Inquiry that the retirement phase is underdeveloped and does not meet the needs of many retirees. It is important that the retirement landscape provides the right settings and choices for retirees to make the best use of their accumulated savings, with relevant and responsive products.

Rather than a radical overhaul, Commonwealth Bank believes there are a number of relatively straightforward changes needed to ensure that the superannuation system delivers security in retirement.

4.1 Encouraging the take up of income streams

While the majority of retirement benefits are paid as income streams, most are account based pensions and do not provide longevity protection.

Account based pensions are popular because they allow people flexibility and control over their superannuation assets in retirement to a greater extent than other income streams. Commonwealth Bank believes account based pensions should continue to be the main vehicle for managing superannuation retirement savings.

However, Commonwealth Bank also believes it is in the national interest, and in the interests of retirees, to encourage a higher take-up of income streams that provide longevity protection, and to develop a sustainable retirement income system. Currently in the retail retirement market, only 1.9% of retirement benefits is invested in lifetime annuities.[34]

4.2 Government provision of income streams

The Inquiry has asked if the Government should increase its provision of longevity insurance.[35] Commonwealth Bank remains strongly supportive of the private provision of retirement income products and does not support any proposal for the Government to issue retirement income products. Concerns arising from this proposal include:

- Additional market and longevity risk on the Government's balance sheet, beyond the fiscal burden

34 Plan for Life March 2014
35 *Interim Report*, page 4-32.

taxpayers already bear from the Age Pension;

- Equity concerns arising from resultant subsidy by lower income households with a lower average life expectancy, to higher income households with higher average life expectancies;
- Likely issues and risks in developing fair pricing where the Government may not be able to discriminate on the basis of gender or smoking status in a similar manner to the private sector, or account for higher life expectancy and adverse selection issues; and
- Crowding out the private sector and acting as a barrier to the development of innovative longevity risk income streams.

Commonwealth Bank believes that the private sector remains best placed to provide retirement income products to superannuation members.

RECOMMENDATION

The Inquiry should not support any proposals for the Government to issue retirement income products. Such products should be a function of a private market.

5. INCREASING SYSTEM EFFICIENCY AND PUTTING DOWNWARD PRESSURE ON CONSUMER COSTS

The Inquiry observed that fees in Australia's superannuation system are high relative to comparable jurisdictions.

> *"There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system."*[36]

Further fee reductions are expected in the longer term with the implementation of regulatory reforms including MySuper, continued consolidation of superannuation funds, and the potential opening up of the award market for default superannuation funds.

The Inquiry is encouraged to evaluate the total net outcomes of the superannuation system rather than focus solely on fees.

Commonwealth Bank acknowledges recent reports on the level of superannuation fees in Australia, including that released by the Grattan Institute.[37] When reflecting on these reports it is important to remember that the Australian superannuation system can be distinguished from other international pension systems for the following reasons:

- It is a defined contribution system as opposed to a defined benefit system and requires member liquidity (choice of fund and portability), administration of insurance and the provision of financial advice;
- Australia has a higher allocation to equities than other jurisdictions, especially those which are predominantly defined benefit jurisdictions. Looking at countries such as Mexico, Hong Kong and the US where asset mix and scheme design are similar, costs and fees are the same or higher than for equivalent funds in Australia;
- Unlike the situation in a range of other systems, Australian superannuation funds bear the costs of administering taxation; and
- Australia has a significant Self-Managed Superannuation Fund (SMSF) segment, the unique features of which make meaningful international comparisons more challenging.

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36 *Interim Report*, pages xxiii, 1-9, 2-95, 2-99.
37 Minifie, J., Cameron, T., and Savage, J. (2014) Super sting: how to stop Australians paying too much for superannuation, Grattan Institute, Victoria, April 2014. Accessible online at http://grattan.edu.au/wp-content/uploads/2014/05/811-super-sting.pdf

5.1 Fees have been trending down

Increasing competition and consolidation within the superannuation industry have continued to drive fees down over the last 11 years.[38] Industry data collected regularly by Rice Warner Actuaries for the FSC show that average system fees reduced from 1.37% in 2002 to 1.12% in 2013. Commonwealth Bank welcomes an open and informed debate on the matter and believes further international fee analysis is necessary in order to achieve definitive conclusions.

5.2 Future trends impacting on fees

5.2.1 Lower fees due to regulatory reforms

In recent years, a range of regulatory changes has been introduced, including the introduction of MySuper default products, increased governance and transparency measures through Stronger Super reforms, SuperStream and continued refinements to tax related concessions. These reforms are likely to drive down fees over the long term. In the short term costs are likely to rise due to the initial costs of implementing these reforms.[39]

Some examples of regulatory-driven fee reductions include:

- MySuper and other new generation superannuation products are delivering low-cost products for customers;
- The MySuper Accrued Default Amount (ADA) transition requirements require a significant number of members to be transitioned to MySuper by 2017. This will reduce aggregate fees paid by default superannuation members currently in non-MySuper products;[40]
- SuperStream is focused on streamlining processes (e.g. facilitating transfer between funds) and driving technology efficiencies, which will reduce fund costs in the long term and enhance customer engagement;
- APRA prudential regulation is expected to be a driver towards continued fund consolidation, in particular the requirement for MySuper trustees to determine annually whether the fund has appropriate scale;[41]
- The Australian Securities and Investment Commission (ASIC) is currently reviewing fee disclosure regulations, which will likely result in increased fee transparency, comparability and drive industry competition; and
- Trustees are no longer able to charge entry fees and exit fees but may only charge on a cost recovery basis.

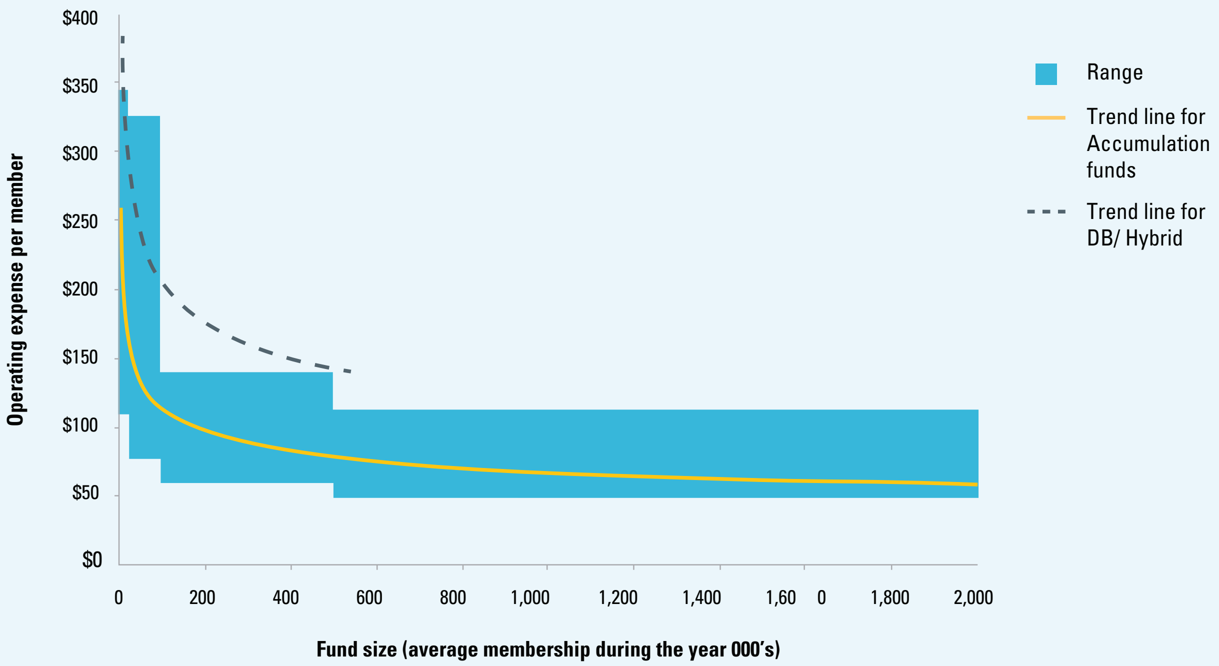
These reforms are still being implemented. However, Commonwealth Bank expects that as these reforms are embedded, customers should expect to see continued downward pressure on fees.

5.2.2 Realisation of cost savings via continued fund consolidation

Industry analysts have noted the impact of fund size on the per member cost of administration and investment. Reductions in administration operating expenses are generally achieved where funds have at least 600,000 members (see Figure 1).[42] Rice Warner also suggests that funds above $10 billion in assets have lower investment expenses than smaller funds (see Figure 2).[43] These studies indicate the potential for lower fees as funds grow in size.

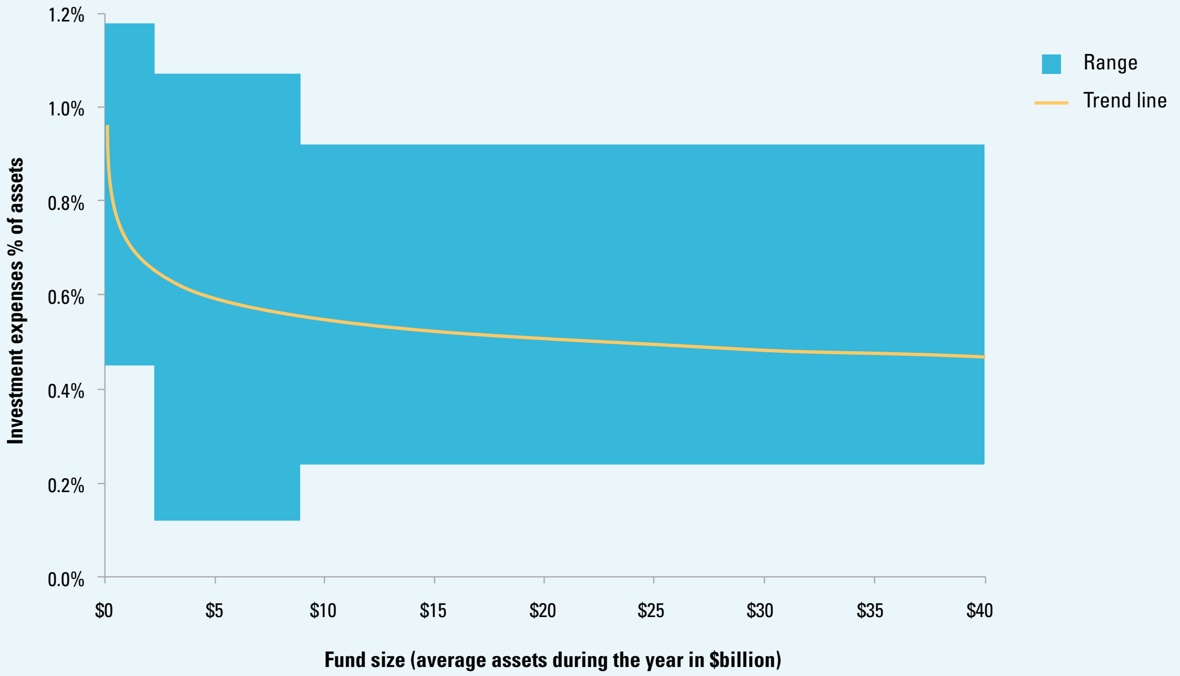
38 Rice Warner (2014) FSC Superannuation Fees Report 2013, Report for FSC, May 2014. Accessible online at http://ricewarner.com/media/96729/Rpt-FSC-Superannuation-Fees-Report-2013-FINAL.pdf
39 Rice Warner, FSC Superannuation Fees Report 2013, op. cit., pages 12 and 14; and Tria Investment Partners, presentation by Andrew Baker for ASFA conference 2013, “Attack of the Clones: Stronger Super and the competitive landscape”, slide 23.
40 Australian Government (2011) Regulation Impact Statement: Stronger Super implementation, September 2011, page 18. Accessible online at http://ris.finance.gov.au/files/2011/10/03-Stronger-Super-RIS.pdf
41 Section 29VN of the *Superannuation Industry (Supervision) Act 1993*
42 Rice Warner Actuaries (2012) Superannuation fund expense analysis, Research for ASFA by Rice Warner Actuaries, May 2012, page 5.
43 ibid.

Figure 1: Operating expenses per member by fund size (membership)



Source: ASFA (2012) Superannuation fund expense analysis.[44]

Figure 2: Investment expenses by fund size (net assets)



* The fitted curve is based on the distribution of all data, not just the three points in the weighted average.
Source: ASFA (2012) Superannuation fund expense analysis.[45]

44 Rice Warner Actuaries (2012) Superannuation fund expense analysis, Research for ASFA by Rice Warner Actuaries, May 2012, page 10.
45 ibid, page 11

The superannuation industry is experiencing consolidation which will continue to drive down fees. APRA statistics show that *"The number of RSE licensees reduced by 19 to 190, over 2012/13 before declining further to 179 as at 31 December 2013. [And] The number of APRA-regulated funds with more than four members declined by 28, from 333 to 305 entities over 2012/13. This number fell further to 290 entities by 31 December 2013"*[46] As Rice Warner notes: *"Fund consolidations have resulted in increased scale and lower fees across the industry…a number of mergers between industry funds and some between retail corporate master trusts resulting in greater economies of scale".*[47]

Overall, the Stronger Super requirements should support the trend towards superannuation fund consolidation as trustees benefit from greater scale.

5.2.3 Realisation of cost savings via opening up of the award market for default superannuation funds

There is significant potential for increased competition and cost reduction in the default superannuation fund market with the opening up of the award market. Consistent with its *First Submission*, Commonwealth Bank continues to support the deregulation of the award default fund market by allowing all employers to choose any MySuper product as the default fund for their award employees.[48] By contrast, the costs to trustees, members, Government and the industry of implementing the current modern award default fund selection process through the Fair Work Commission could exceed $400 million.[49]

5.2.3 The net outcome of superannuation benefits is more than just fees

While it is important to drive down fees for the benefit of customers, fees are only one input to consider when assessing system performance.

The Mercer Global Pension Index assesses 20 comparable pension systems from around the world based on three key criteria: Adequacy, Sustainability and Integrity. For 2013, the Australian superannuation system ranked third overall. It came first for 'Integrity', the category that covers regulation, governance, protection, communication and costs.[50]

The features of the current Australian system, including the level of fees across the sector, continue to be influenced by the maturity, profile and structure of the system. This makes conclusive comparisons across markets difficult.

As the industry increasingly becomes more fee sensitive and cost comparative (driven by increased transparency and aggregators), it is important to ensure that trustees do not become overly focused on fee/cost minimisation at the expense of generating optimal returns for members.

Commonwealth Bank encourages the Inquiry to evaluate the total net outcomes of the superannuation system rather than focus excessively on fees.

RECOMMENDATION

Allow the current superannuation settings to mature and re-evaluate after five years.

46 Australian Government—Australia Prudential Regulation Authority (2014) Insight: Issue One, 2014, page 12. Accessible online at http://www.apra.gov.au/Insight/Documents/Insight_Issue1_2014_FINAL.pdf
47 Rice Warner, FSC Superannuation Fees Report 2013, op. cit., page 6.
48 *First Submission*, Chapter 10.
49 Rafe Consulting (2014) Impact of changes to the Fair Work Act on the Australian Superannaution Sector, Employers and their Employees, Report for the Financial Services Council, 16 June 2014, page iii. Accessible online at http://www.fsc.org.au/downloads/uploaded/Default%20funds%20report%20-%202014%2006%2016_fcfb.pdf
50 Australian Centre for Financial Studies and Mercer (2013) Melbourne Mercer Global Pension Index, October 2013, page 6. Accessible online at http://globalpensionindex.com/2013/melbourne-mercer-global-pension-index-2013-report.pdf

PEOPLE WILL BE MORE SUCCESSFUL IN TAKING RESPONSIBILITY FOR THEIR FINANCIAL FUTURES AND WILL MAKE BETTER FINANCIAL CHOICES WHEN THEY FEEL CONFIDENT, ENGAGED, EDUCATED AND INFORMED. COMMBANK CAN.

CHAPTER 2: CONSUMER OUTCOMES

Commonwealth Bank believes that people will be more successful in taking responsibility for their financial futures and will make better financial choices when they feel confident, engaged, educated and informed.

Commonwealth Bank supports measures to contribute to the depth of financial literacy of current and future consumers and to improve the quality and transparency of financial advice across the sector.

Commonwealth Bank agrees with the Inquiry's observations that:

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

Commonwealth Bank agrees with the Inquiry's observation that improved financial literacy is not a panacea for the issues it seeks to address.[51] However, to improve customer outcomes, Commonwealth Bank believes the quality of disclosure and financial advice must be improved, along with financial literacy.

Drawing on the experience in Commonwealth Bank's financial planning businesses, including learning from weaknesses in those businesses in the past, Commonwealth Bank offers views and information on options and related questions, including raising minimum education and competency standards for personal advice and the introduction of an enhanced public register of financial advisers.

1. BOOSTING FINANCIAL LITERACY

Commonwealth Bank shares the Inquiry's interest in addressing low levels of financial and functional literacy to enhance consumer trust, choice and control in their financial activities.[52]

Commonwealth Bank welcomes the release of the *National Financial Literacy Strategy 2014–17* and supports the core actions identified in the Strategy.[53] The Strategy aims to improve the financial wellbeing of Australians by advancing their financial literacy, outlining data on the extent of the problem and areas requiring further attention.

The Programme for International Assessment (PISA) results released in July 2014 found:[54]

- 82% of Australian students and 75% of disadvantaged students have a bank account, a higher rate than the OECD average, and those that do scored a higher than average financial literacy score.[55] However, 10% of students were low performers in financial literacy; and[56]
- 79% of students agreed it was important for them to learn money management at school.[57]

51 *Interim Report*, page 3-60.
52 *First Submission*, pages 96 to 101.
53 Released 1 August 2014. See Australian Government—Australian Securities & Investments Commission (2014) *National Financial Literacy Strategy 2014–17*, July 2014, pages 3 to 4. Accessible online at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep403-published-1-August-2014.pdf/$file/rep403-published-1-August-2014.pdf
54 Australian Council for Educational Research (2014) Financing the Future: Australian students' results in the PISA 2012 Financial Literacy assessment, July 2014. Accessible online at http://www.acer.edu.au/files/PISA_2012_Financial_Literacy.pdf
55 ibid, page viii.
56 ibid, page vi.
57 ibid, page 65.

In its *First Submission*, Commonwealth Bank detailed its activities and commitment to supporting financial literacy through long standing programs delivered by the Commonwealth Bank Foundation. These include StartSmart, a free non-promotional program reaching 288,728 students in primary, secondary and vocational education settings in the 2013–2014 financial year. StartSmart is having a positive impact on the financial literacy of students.[58]

There are three main factors that affect a young person's financial wellbeing – financial education, appropriate products and the opportunity to use money. According to the World Savings and Retail Banking Institute, "to achieve true financial capability, people need not only the ability to act through financial education, knowledge, skills, confidence and motivation, but also the opportunity to act through access to adequate banking services and institutions. Without access to these banking products, they will not build the skills necessary to learn how to use financial services in a productive and responsible manner."[59] Given the increasing use of technology to deliver financial services, it will be critical for future generations to be digitally literate so that they understand and plan for their financial circumstances.

RECOMMENDATIONS

- Encourage the broad involvement of stakeholders, including the government, business, community and education sectors, in the implementation of the *National Financial Literacy Strategy 2014–17* to further inform the Inquiry's recommendations;
- Increase the level and frequency of financial literacy included in school curriculums, and improve the consistency of the curriculum across the States and Territories; and
- The Inquiry should consider further integration of digital education into the national school curriculum and further incentives for children to learn computer skills to ensure they are equipped to interact with the financial system of the future.

58 Note: This figure is correct as of 1 August 2014. StartSmart is free and does not promote the product or services of the Commonwealth Bank. See also Commonwealth Bank of Australia (2013) StartSmart Impact Report, 2013, pages 6 and 18. Accessible online at https://www.commbank.com.au/content/dam/commbank/about-us/who-we-are/financial-literacy/docs/StartSmart-Impact-Report.pdf

59 World Savings Banks Institute (2011) WSBI member banks' experiences in the field of financial education: Examples and policy views, June 2011, page 5. Also cited in Child and Youth Finance Intearnational (CYFI) and MasterCard Incorporated International (2014) Banking a new generation: Developing responsible retail banking products for children and youth, March 2014. Accessible online at http://www.childfinanceinternational.org/resources/publications/2014-banking-a-new-generation.pdf

2. DISCLOSURE REQUIREMENTS SHOULD WORK FOR CUSTOMERS

Commonwealth Bank agrees with observations made by the Inquiry[60] that the current product disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.

Commonwealth Bank supports several options proposed by the Inquiry including the use of mechanisms to enhance consumer understanding, such as layered disclosure, risk profile disclosure, removing disclosure requirements that are ineffective and facilitating new ways of providing information.

In Commonwealth Bank's experience, people increasingly want to receive information on a mobile device. They want simple, direct information in plain English, which provides a clear understanding of the benefits, costs and risks relevant to themselves and their situation.

Disclosure requirements should be driven by the nature of the underlying product and consideration of the information needed to facilitate consumer understanding. Disclosure requirements should not drive product design or limit innovation in product features or services that better meet the needs of consumers.

Commonwealth Bank supports the concepts proposed in the Inquiry to improve disclosure, particularly layered disclosure and better information presentation. Legislation, regulations and industry codes should be amended to allow disclosure requirements to be satisfied in more consumer-friendly ways.

Commonwealth Bank commits to work with government, consumers and regulators to develop fresh approaches that deliver the information people value in the form most useful to them.

RECOMMENDATIONS

- A taskforce should be established which includes representatives of consumers, government, regulators and industry, to design an evidence-based, technology-neutral and effective framework for disclosure content and delivery. Commonwealth Bank commits to participate in a taskforce that helps improve disclosure;
- Disclosure requirements that have proven ineffective should be removed, and new ways to provide information to consumers including technology and electronic delivery, should be facilitated;
- Specifically, disclosure requirements of Chapter 7 of the *Corporations Act 2001*, the National Credit Code and industry codes should be reviewed to deliver a uniform technology-neutral approach to disclosure delivery, embracing where appropriate new and evolving technologies including smart phone usage with content available through links to social media;
- The Commonwealth, States and Territories should work together to ensure a consistent approach regarding electronic disclosure wherever possible;
- Appropriate disclosure requirements should be developed to facilitate consumer understanding of products ranging from simple to complex; and
- Product design requirements should allow product issuers to design products that enhance competition, innovation, availability and affordability for consumers.

60 *Interim Report*, page 3-49.

3. TECHNOLOGY

3.1 Technology contributes to efficiency and accountability in customers' interests

Commonwealth Bank utilises technology to enhance the customer experience, and drive down costs to maximise returns to shareholders and value to customers. Extensive detail on the role of technology in delivering the future vision of the Australian financial system was provided in the *First Submission*.[61]

The technology environment is evolving rapidly. Since April 2012, Commonwealth Bank has seen NetBank logins via mobile devices increase from around 40% to 60%.[62] Consistent with the Inquiry's observations, Commonwealth Bank believes that to maximise innovation the future regulatory and practice framework should be technology-neutral. It should provide incentives to take-up technologies that help reduce costs and improve accountability. As a principle, Commonwealth Bank believes the take-up of technology must not compromise the pursuit of systemic stability through the use of unevenly regulated technology.

3.2 Technology contributes to boosting financial literacy

Technology has a major role to play in boosting the financial literacy of Australians, enabling them to be confident users of the financial system and to take more control of their own financial decisions.

3.3 Regulatory anachronisms limit technology innovation

The Inquiry noted the existence of out-dated regulations and laws prescribing redundant or inappropriate technologies.

Commonwealth Bank agrees that there is a need to replace these limiters of innovation with relevant, technology-neutral text. This will assist to clarify interpretation and stimulate innovation.

The Inquiry requested further information on what specific regulation and legislative requirements should be prioritised.[63]

Commonwealth Bank believes the growing number of textual anachronisms in statutes requires urgent 'housekeeping'.

Commonwealth Bank proposes that the Government considers convening a taskforce, including government representatives and industry. The taskforce could compile a miscellaneous statutes amendment bill to identify agreed and non-controversial red-tape 'quick wins'. Commonwealth Bank commits to participate in this taskforce.

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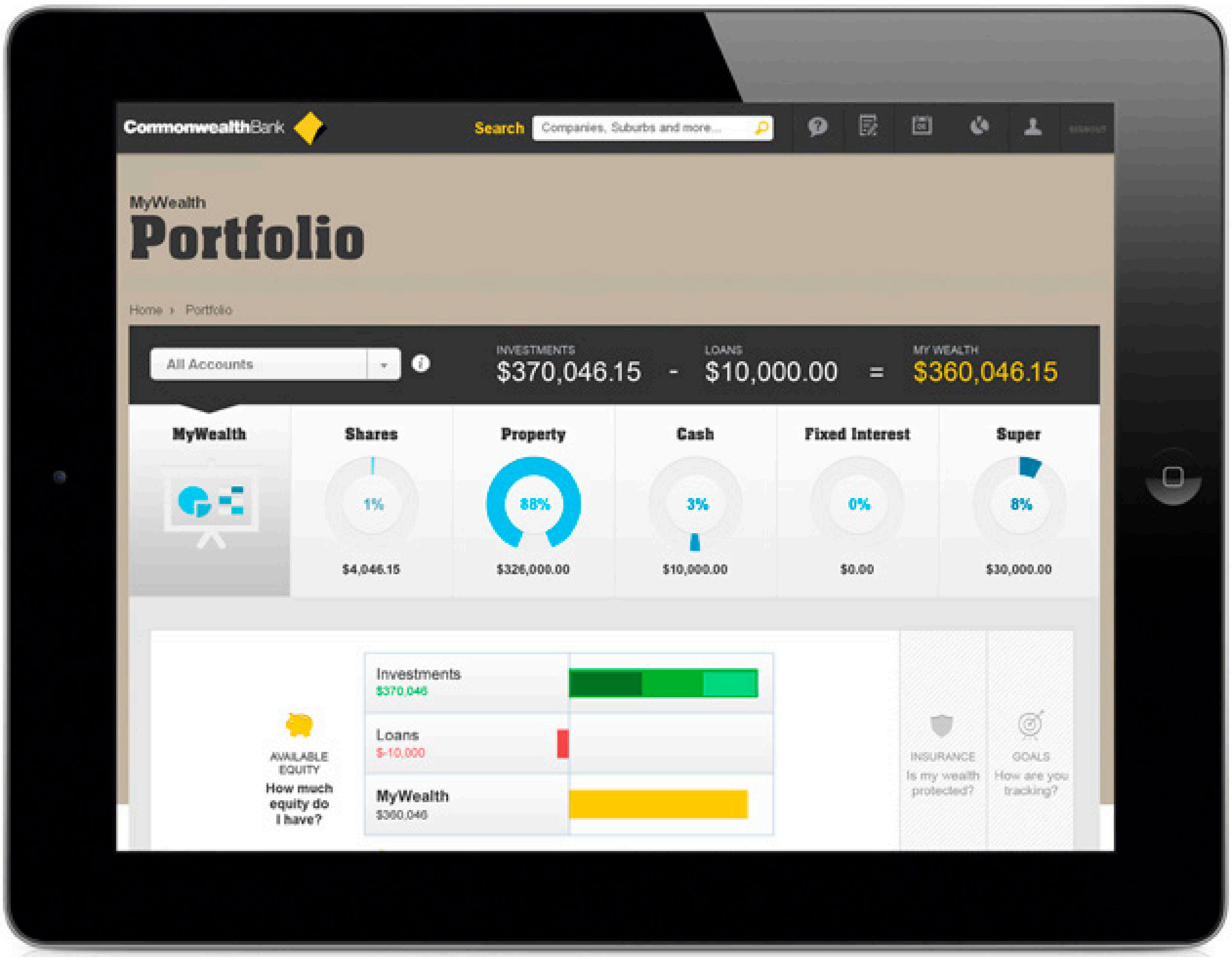
61 *First Submission*, Section III, 'Protecting Australians in the Digital Economy'
62 Commonwealth Bank of Australia (2014) Results Presentation for the Full Year ended 30 June 2014, 13 August 2014, page 93. Accessible online at https://www.commbank.com.au/content/dam/commbank/about-us/shareholders/pdfs/results/fy14_results_presentation.pdf
63 *Interim Report*, page 4-45.



TECHNOLOGY ENHANCES THE CUSTOMER EXPERIENCE, ASSISTING AUSTRALIANS TO TAKE MORE CONTROL OF THEIR OWN FINANCIAL DECISIONS. COMMBANK CAN.

RECOMMENDATIONS

- Review the *Electronic Transactions Act 1999* and its interaction with other legislation such as the *Corporations Act 2001* and regulatory guidance to better meet the needs of consumers;
- Remove regulatory barriers to provide online guidance, to make it more accessible and affordable, especially for young people;
- Set minimum standards for digital delivery of online guidance (consistent with objectives outlined to deliver enhanced consumer outcomes).
  Such standards should be set by Government in consultation with industry and consumer advocates, and promote technology-neutrality; and
- Establish a taskforce to immediately identify statutory technology anachronisms and prepare a draft amendment bill to address the consequences of rapid digital evolution.

3.4 Government oversight of technology-based services

Technology-based services are now so fundamental to the commercial and social wellbeing of Australians and Australian business, and the speed of change so relentless, that new structures within government in relation to the digital economy have become necessary. The rise of new technologies is creating both significant opportunities and risks for organisations and customers alike. Public policy and regulatory oversight should:

- Maximise the digital advantage available to the Australian economy while balancing the potential systemic and privacy risks;
- Ensure consistent and equitable oversight of participants in key sectors such as banking; and
- Encourage and facilitate the safe use of technology by consumers.

4. QUALITY FINANCIAL ADVICE

Historical experience in Commonwealth Financial Planning Limited (CFP) and Financial Wisdom Limited (FWL) has been the catalyst for exhaustive overhaul of conduct and standards in these businesses, in order to meet the legitimately high expectations of consumers.

On 18 July 2014, the Commonwealth Bank Group announced new minimum education standards for financial planners, supervisors and managers of planners.[64]

These new standards exceed current industry requirements.

4.1 Higher standards in adviser education

Commonwealth Bank supports increasing current minimum education standards required of financial advisers who provide personal advice to retail clients. Additional measures that safeguard the trust of customers and raise the standards in the financial advice industry more broadly are also endorsed.

CBA recognises the industry will need time to transition to new standards as many longstanding quality advisers, who run their own small and medium sized planning businesses, would not immediately achieve them.

4.2 Public register

Commonwealth Bank supports the creation of an enhanced public register for all financial advisers, including employee representatives. This would provide customers with visibility into individual financial advisers while equipping regulators with the ability to monitor and track advisers.

International jurisdictions such as the US currently administer individual registration of financial advisers. Customers who are seeking to use the services of a US registered investment adviser are able to view individual investment adviser representative records that include information about that individual's professional background and conduct, including current registrations, employment history, and disclosures about certain disciplinary events involving the individual.

RECOMMENDATION

Government should work closely with industry on feedback associated with the Treasury discussion paper in relation to the public register.

64 See Commonwealth Bank of Australia (2014) "Commonwealth Bank raises educational standards for financial planners", Media Release on 18 July 2014. Accessible online at https://www.commbank.com.au/about-us/news/media-releases/2014/commonwealth-bank-raises-educational-standards-for-financial-planners.html

4.3 Establish clearer definition of financial advice and sales information

Commonwealth Bank endorses the Inquiry's observation that

> *"Consumers should have access to the information, advice and education necessary to make effective decisions about products and services…..services should be accurately described, and perform as they are described….."*[65]

The Inquiry invited views on policy options to rename general advice as 'sales' or 'product information' and mandate that the term 'advice' can only be used in relation to personal advice.[66]

Commonwealth Bank recommends that general advice should be renamed as 'sales' or 'product information' and the term 'advice' should be used only in relation to personal advice. Providers of sales or product information should not be regulated as advice providers, as they are not providing financial advice.

Benefits to consumers would include:

- Consumers are better able to determine whether they are seeking sales or product information, or financial advice with services;
- Consumers can decide on their appropriate use of sales or product information;
- Clarity for consumers of the role of financial advisers as professionals; and
- Improved clarity and choice for consumers over the particular services they seek with the trend towards simpler products delivered both on-line and directly, such as MySuper.

These changes will serve to increase professionalism and accountability in the system, with distinct and appropriate regulatory regimes applying to advice providers and to sales or product information providers.

ASIC has stated that for many consumers, general advice or factual information is sufficient to deal with advice needs at a particular point in time and that improving access to advice involves a combination of helping get better personal financial advice as well as helping consumers access general advice and information.[67]

The Tax Practitioners Board (TPB), in setting its new framework to regulate tax (financial) advice (tax advice delivered by financial planners in the course of providing financial advice), provided appropriate exemptions for general advice from the framework and associated requirements. Commonwealth Bank endorses this decision.

RECOMMENDATIONS

- General advice should be renamed as 'sales' or 'product information' and the term 'advice' should only be used in relation to personal advice; and
- Commonwealth Bank believes providers of sales or product information should not be regulated as advice providers, where they are not providing financial advice.

65 *Interim Report*, page 3-50.
66 ibid, pages xxxii and 3-74.
67 ASIC has expressed views that "the provision of general advice or factual information is less extensive than it could be. For many consumers, general advice and factual information is sufficient to deal with their advice needs at a particular point in time" and "improving access to advice involves a combination of helping consumers get better personal financial advice as well as helping consumers access general advice and information." See Australian Government—Australian Securities & Investments Commission (2010) Report 224: Access to financial advice in Australia, December 2010. Accessible online at https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep224.pdf/$file/rep224.pdf

SECTION 2: BUILDING ON SOLID FOUNDATIONS

Wellbeing, Prosperity, Resilience.

> 'In the 16 years since the Wallis Inquiry, the economy has performed well – this period being part of 21 years of uninterrupted growth. Our economic profile has, however, not changed much over history – that of a small, open commodity based economy, active and successful at investment but making extensive use of foreign capital. We have opened up the economy to our benefit but that brings with it the risk of being buffeted by global events.'
> – David Murray AO, Chairman, FSI Inquiry [68]

Commonwealth Bank endorses the observations of the Inquiry that the Australian financial system has performed reasonably well in meeting the financial needs of Australians, and in facilitating productivity and economic growth. Commonwealth Bank also agrees with the observation that there is no room for complacency.[69]

Commonwealth Bank's *First Submission* encouraged the Inquiry to preserve what has proven to be of most value to the economy, customers and the community.[70]

Compared to many jurisdictions, Australia's financial system proved resilient during the GFC. APRA attributes this resilience to its supervisory framework, which placed a priority on understanding and promoting the drivers of financial health prior to the crisis.[71]

In Commonwealth Bank's view, a combination of proactive supervision and principles-based regulation is the most effective way to ensure the stability of the Australian financial system and delivery of appropriate safeguards for consumers.

In addition, competition within Australia and within global markets is essential to future success. Having opened its economy to external opportunities, Australia must be sure its financial system enables domestic enterprises to compete.

Strong competitive markets place downward pressures on costs and promote product diversity and quality, to the advantage of consumers.

Australia is in the fortunate position of having solid foundations on which to build. These include:

- A financial sector that is competitive and energetic;
- Highly skilled individuals and appropriate regulatory practices which minimised the impact of the GFC on Australia;

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68 Murray AO, David, op. cit.
69 *Interim Report*, page xv.
70 *First submission*, page 6.
71 Laker, John F. (2010) "Supervisory Lessons From The Global Financial Crisis", Speech by the then APRA Chairman at the AB+F Leaders Lecture Lunch in Sydney, 8 December 2010.

- A national psyche in which Australians have always looked beyond the nation's borders in commerce, culture and engagement to assist others; and
- A can-do approach that is part of the national character, particularly in the small and medium enterprise sector.

Commonwealth Bank offers views, information and recommendations on issues raised by the Inquiry, particularly:

- The small and medium enterprise (SME) sector;
- Creating a level playing field for smaller banks;
- Expansion of Comprehensive Credit Reporting; and
- Vertically integrated organisations.

CHAPTER 3: FINANCE SECTOR SUPERVISION

The GFC demonstrated that rule driven frameworks in some jurisdictions have fostered a culture of strict compliance without delivering superior risk management or consumer benefits. For example, following the GFC, the UK Government, in consulting on its reforms of the banking sector, observed that: "in the run up to the financial crisis, financial supervision relied too much on 'tick-box' compliance with rules and directives, at the expense of proper in-depth and strategic analysis."[72]

Post-GFC, international regulatory reforms have acted to strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector which can absorb shocks from financial or economic stresses and limit spill over to the real economy.

Financial markets are constantly evolving and even with state-of-the-art systems, not all risks can be predicted nor tail risks measured, notwithstanding the complexity of the models and rules deployed. For this reason a proactive, even intrusive supervisory approach, may usefully complement the post-GFC regulatory reform agenda and help identify and counter potentially disruptive activities or behaviours before they evolve into drivers of systemic instability or adverse customer outcomes.

Rather than additional regulation or requirements, emphasis should be placed on building and enhancing financial sector supervisory models that are forward looking and adequately resourced. Such models should promote the governance structures, corporate culture and management systems within financial institutions that will enable a firm to operate within prudent strategic settings and respond to emerging systemic risks. Supervision should be proactive, comprehensive and flexible enough to adapt to the constantly evolving and innovating nature of financial services. Supervisors should be armed with sufficient resources and a clear strategy to ensure that they can supervise effectively.

A strong pre-emptive supervisory approach can foster improvements in governance and culture within financial organisations. For example, ASIC has observed that culture is the key to changing behaviours in financial institutions, not regulation, and notes that while much action has been taken globally to ensure that there is not a repeat of the GFC, more focus should be given to governance and culture.[73]

Within a financial institution, the Board has the ultimate responsibility for ensuring the application of prudent management standards. A Board sets the boundaries for risk-taking and needs to ensure an appropriate risk culture permeates the business and that senior management take the steps necessary

72 UK Government Consultation Paper, "A new approach to financial regulation: judgement, focus and stability", 26 July 2010. Accessible online at https://www.gov.uk/government/consultations/a-new-approach-to-financial-regulation-judgement-focus-and-stability
The Financial Conduct Authority's (FCA) Director of Supervision has also commented that the 'box-ticking' approach of its predecessor (Financial Services Authority) "led to, in effect…the sense that everything will be ok if compliance listens to all the rules and its built around that." – Speech, Clive Adamson, Director of Supervision, FCA, "A sustainable conduct environment", 20 March 2014.

73 Greg Medcraft, ASIC, Interview with the Centre for International Finance and Regulation, 2014

SUPERVISION SHOULD BE PROACTIVE, COMPREHENSIVE AND FLEXIBLE ENOUGH TO ADAPT TO THE CONSTANTLY EVOLVING AND INNOVATING NATURE OF FINANCIAL SERVICES. COMMBANK CAN.

to manage and monitor all material risks within the tolerances the Board has prescribed. In exercising its responsibilities, a Board should be able operate free of any ambiguity as to the respective functions that it and senior management are expected to perform. A principles-based approach to regulation should allow directors to address their responsibilities by having regard to the entity's particular settings, size, business mix and complexity.

An active supervisory model, underpinned by principles-based regulation and focussed on strong corporate governance, prudent risk culture and real customer outcomes, will significantly reduce the risk that any firm will encounter financial difficulties or lead to delivery of adverse outcomes for consumers.

RECOMMENDATION

Emphasis should be placed on building and enhancing financial sector supervisory models that are forward looking and which promote the governance structures, corporate culture and management systems within financial institutions that will enable a firm to operate within prudent strategic settings and respond to emerging systemic risks.


COMMONWEALTH BANK BELIEVES THERE IS MERIT IN EXPLORING THE POTENTIAL FOR AN INVESTMENT FUND FOR EMERGING SME BUSINESSES.
COMMBANK CAN.

CHAPTER 4: SMALL AND MEDIUM-SIZED ENTERPRISES

The small and medium enterprise (SME) sector provides 70% of Australian private sector industry employment,[74] generating innovation and competition. An objective of the financial system must therefore be to ensure that SMEs have access to appropriate finance for new and growing enterprises, and are assisted to fully represent their genuine strengths when seeking finance.

Commonwealth Bank acknowledges the Inquiry's observation that there are structural impediments for small and medium-sized enterprises to access finance, including information asymmetries, regulation and taxation.[75]

Drawing on its long experience in working with the SME sector, Commonwealth Bank endorses the recognition the Inquiry gives to the importance of SMEs in the national economy. Of more than two million SMEs across the nation, Commonwealth Bank is proud to serve approximately 450,000 SME customers.[76]

The Inquiry invited further information on the prices, benefits and trade-offs on policy options or other alternatives including the development of an SME finance database to reduce information asymmetries between lenders and borrowers and options to narrow the informational gaps between lenders and SME borrowers.[77] These issues are addressed through discussion on:

- SME financial literacy and simplifying the loan application process;
- Information asymmetry and a proposed finance database;
- Access to finance for start-ups; and
- Regulation.

1. SME FINANCIAL LITERACY AND SIMPLIFYING THE LOAN APPLICATION PROCESS

More financially literate and confident SMEs should reduce the scope and depth of regulatory imperatives over time. Commonwealth Bank provides the following information on a number of services it has initiated to improve financial literacy and simplify the loan application process for its SME customers:

- Access to business specialists from every branch via Video Conferencing and 24/7 access to business bankers through the Business Service Centre;
- Daily iQ, a daily analytics tool that provides high level analysis of an individual business cash flow, merchant sales and customer demographics;
- A Simple Business Overdraft process for existing eligible Commonwealth Bank clients, that facilitates the rapid establishment of an overdraft facility; and
- Online resources, including a business plan and cash flow forecasting tools, and online applications for business transaction and savings accounts.

Commonwealth Bank continues to invest in technology platforms and digital channels to simplify processes for SME clients.

74 Australian Government—Department of Industry, Innovation, Science, Research and Tertiary Education (2012) Australian Small Business – Key Statistics and Analysis, December 2012, page 23. Accessible online at http://www.treasury.gov.au/PublicationsAndMedia/Publications/2012/sml-bus
75 *Interim Report*, page 2-61.
76 Refers to small and medium businesses with annual turnover below $20 million that hold at least one business product with the Commonwealth Bank.
77 *Interim Report*, page 2-68.

2. INFORMATION ASYMMETRY AND FINANCE DATABASE

Banks' underwriting decisions are based on information such as the nature of a business, business financials, credit history, and the owner's financial history. Lenders do not always have access to this information, particularly for smaller and earlier-stage businesses with less sophisticated business and financial management practices, even though some of the required information may be otherwise available.

The Inquiry has proposed consideration be given to a government-led SME finance database to address information asymmetry.[78] Commonwealth Bank welcomes the opportunity to work with government to participate in the development of a centralised SME information portal.

The information most needed by banks for decision making already exists within various arms of government. Typical searches which lenders undertake are:

- Title searches, showing details of registered owner, security, easements, charge holders, and date of mortgage;
- Company searches, including organisation details from ASIC (such as company details, registered offices, places of business, directors, secretaries, share structures, members and previous members, date of lodgement of annual tax returns, securities, and ASIC documents);
- Personal searches and ASIC extracts on individuals (such as directorships, secretary roles, licences held, shareholdings and documents lodged);
- National Personal Insolvency Searches, including information showing names, alias, date of birth, and any administration or bankruptcy notices;
- Security searches from the Personal Property Security Reform (PPSR) register; and
- Review of Australian Taxation Office company annual returns and Business Activity Statements, showing trading performance of a business, allowing banks to check key elements of company financial statements.

A government sponsored and supported SME information portal would help promote competition by providing lenders with electronic access to an integrated and holistic view of government-held, but publicly available information.

3. ACCESS TO FINANCE FOR START–UPS

There is a clear difference between the ability of an established SME with a demonstrated capacity to service and repay a loan, and the ability of a SME start-up venture with minimal historical information to source finance. This is largely because SME start-up ventures often carry 'equity-like' risk.

The provision of equity or the acceptance of 'equity-like' risk has not historically been a natural role for banks who are primarily debt providers.

In this context, Commonwealth Bank believes there is merit in exploring the potential for an SME investment fund as a stand-alone entity using funds from government and a broad range of financial services institutions to provide funding to emerging SME businesses.

The UK established a similar concept in 2011 called the *Business Growth Fund* (BGF)[79] with Financial Services Authority (FSA) and major bank support (see Case Study 1).

78 *Interim Report*, page 2-68.
79 BGF (2014) BGF Review 2013/2014. Accessible online at http://www.businessgrowthfund.co.uk/wp-content/uploads/2014/06/BGF-REVIEW-2014-.pdf

To be effective, such a fund would need to be managed on an arm's length basis with an independent executive and staff. Investment opportunities would need to be evaluated on a commercial basis.

The capital treatment of any contributions to such a fund (by banks in particular) would be an important consideration. Specifically, Commonwealth Bank believes that bank participation in such an investment fund should be contingent upon the Basel equity investment concessional threshold approach being applied to any funding provided.

Commonwealth Bank would be prepared to discuss potential participation in such a fund based on parameters relevant to the Australian SME market and policy objectives.

CASE STUDY 1: THE UK BUSINESS GROWTH FUND

The BGF, established in 2011, seeks investment opportunities in businesses with a proven business model, a desire to grow and a management team with a good track record. It typically invests between £2 million to £10 million of growth capital for up to 10 years in a business in exchange for a minority equity stake and a board seat. These businesses are privately owned, profitable companies typically with a turnover of £5 million to £100 million. These investments use BGF's own balance sheet.

The BGF invests in all sectors except financial services and property and adopts a strong local approach with offices based in regional centres around the UK.

BGF now has investments in 8 segments of the UK economy with investments ranging from £2.25 million to £10 million (an average of £4.8 million).

After 2 years of operation there are almost 3,500 people working within BGF portfolio companies with almost 8% of them being new jobs created attributed to BGF investment.

4. REGULATION

The Basel Accord introduced a €1 million threshold[80] to differentiate between retail exposures, which can be statistically managed, and corporate exposures which needed to be individually risk rated.[81] Subject to its own interpretation of the Accord, APRA subsequently adopted a $1 million AUD threshold to distinguish between what it has defined as the SME Retail Asset and SME Corporate Asset Classes.[82]

Commonwealth Bank recommends the Inquiry consider increasing the definitional threshold to at least $1.5 million. This would:

- Align APRA's prudential standards closer to the original intent of the Accord;[83]
- Eliminate a longstanding source of competitive disadvantage for Australian advanced Internal Ratings Based (IRB) institutions compared to their international peers and subsidiaries operating in the Australian market that are not subject to the same regulation;[84] and
- Allow Australian banks to further simplify their origination, credit decisioning and in-life customer management processes for business loans.

RECOMMENDATIONS

- Support efforts to improve SME financial literacy and business acumen, including initiatives to provide SMEs with improved access to information and advice on accessing funding to support their business at different life stages;
- Support efforts to simplify the processes for SME loan applications, particularly through the innovative use of technology and digital channels, and consistent with recommendations on technology-neutrality, simpler disclosure, and accessible financial information;
- Examine the concept of a government-led SME finance database using government held, but publicly available information, with a centralised SME information portal;
- Consider the potential for an SME investment fund as a stand-alone entity using funds from government and a broad range of financial services institutions to provide funding to emerging SME businesses. The UK *Business Growth Fund* (BGF) could offer a useful model; and
- Increase the definitional threshold between SME Retail and Corporate loans, in line with international peers, to at least $1.5 million.

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80 See paragraph 231 in Bank for International Settlements, "Part 2: The First Pillar—Minimum Capital Requirements". Accessible online at http://www.bis.org/publ/bcbs128b.pdf

81 See paragraphs 40, 41, 45 in Australian Government—Australian Prudential Regulation Authority (2008) Capital Adequacy: Internal Ratings-based Approach to Credit Risk, Prudential Standard APS 113, January 2008. Accessible online at http://www.apra.gov.au/adi/Documents/cfdocs/Final-APS-113-November-2007.pdf

82 Australian Government—Australian Prudential Regulation Authority (2005) Discussion Paper: Implementation of the Basel II Capital Framework 3. Internal ratings-based approach to credit risk, 28 July 2005, page 5. Accessible online at http://www.apra.gov.au/adi/Documents/cfdocs/dp0023.pdf reference page 5; and APRA Prudential Standard APS 113, op.cit., paragraph 45.

83 ibid

84 APRA Prudential Standard APS 113, paragraph 45 and footnote 4.

REFORMS CAN BE MADE TO ACCOMMODATE AND MAINTAIN COMPETITION IN THE SYSTEM. COMMBANK CAN.

CHAPTER 5: INCREASING COMPETITIVENESS, MORTGAGE RISK WEIGHTING

Commonwealth Bank welcomes the discussion on competition in the financial system. The Treasurer's Terms of Reference to the Inquiry called for its recommendations to promote a competitive and stable financial system that contributes to Australia's productivity growth.[85] It is important that in the pursuit of increased competition, measures are not introduced that put at risk the stability of individual banks or the system.

Commonwealth Bank acknowledges the competitive role provided by smaller banks, and believes reforms can be made to accommodate and maintain competition in the system.

1. INTERNAL RATINGS BASED RISK WEIGHTS

Commonwealth Bank agrees with the observation that the banking sector is competitive, despite its concentration.[86] However, due to structural differences in the sector between the larger and smaller banks, the larger banks may have a perceived advantage from the use of IRB risk weights.

A bank's employment of an IRB approach to credit risk is conditional upon it securing approval to use the Advanced Measurement Approach (AMA) to Operational Risk and the Internal Model Approach (IMA) to Interest Rate Risk in the Banking Book (IRRBB). This conditional linkage is an APRA requirement and is not observed in other jurisdictions. Relaxation of this dependency could facilitate accelerated IRB approval for smaller banks.

IRB status necessitates ongoing investment by a bank in its risk management frameworks, internal controls and quantitative modelling capabilities. Most of these costs are not variable, unlike capital charges, meaning the burden is relatively higher for smaller banks. A government program, designed with APRA's assistance, may be beneficial to guide smaller banks towards IRB accreditation.

85 Hockey MP, the Hon Joe Treasurer (2013) Financial System Inquiry (Media Release), 20 December 2013.
86 *Interim Report*, page xviii

IRB accreditation may also be usefully applied to only material portions of credit portfolios, for example housing loans, which should speed up the approval process.

These initiatives may be helpful to smaller financial institutions (FIs). Competition in the banking market manifests itself in a myriad of factors other than capital ratios, including pricing, product differentiation, customer service, convenience and innovation.

The Inquiry has also proposed policy options to advance the competitive position of smaller banks including increased IRB risk weights of the major banks, or lower standardised risk weights.

Any competitive advantages the major banks receive from IRB credit modelling are moderated by additional capital buffers, e.g. domestic systemically important bank (D-SIB) and IRRBB capital buffers which are not imposed upon non-IRB banks. The 20% Loss Given Default floor makes the IRB approach conservative. Increasing IRB risk weights may impact industry wide credit pricing and availability. In contrast, standardised risk weights are currently in excess of Basel Committee on Banking Supervision (BCBS) minimums. Some degree of relaxation in these risk weights (subject to BCBS floors) may facilitate greater pricing competition.

RECOMMENDATIONS

- Subject to APRA being satisfied, Commonwealth Bank would support measures to assist smaller banks to achieve IRB status, and therefore potentially lower their lending risk weights including:
  - Relaxation of standardised risk weights (currently set by APRA above Basel minimums);
  - Removal of the dependency that IRB accreditation is contingent upon approval to use AMA for operational risk and IMA for IRRBB;
  - Allowing IRB accreditation to apply only to the material portfolios of a bank such as mortgages (i.e. small portfolios could remain as Standardised); and
  - A Government program designed in conjunction with APRA to assist smaller banks to establish the models and frameworks needed for IRB accreditation.
- Any changes to APRA's capital requirements would need to satisfy BCBS standards and not undermine systemic stability.

CHAPTER 6: EXPANSION OF COMPREHENSIVE CREDIT REPORTING

The Inquiry sought views on policy options to expand and extend Comprehensive Credit Reporting (CCR).[87] Commonwealth Bank believes that mandatory CCR is not necessary as there are still a number of potential unintended consequences associated with its implementation. Lenders should be permitted to transition in line with their ability to upgrade systems and processes over time once these issues have been satisfactorily resolved.

These issues include:

- The accuracy of the information collected under an extended CCR system. The Office of the Privacy Commissioner (OPC) has noted that "expanding the volume and depth of information that would be available on individuals' credit information files may worsen the current problems with accuracy of credit information";[88]
- Data security incidents overseas have seen the security of comprehensive credit reporting information compromised by credit reporting agencies;[89] and
- It is premature to be suggesting changes to Comprehensive Reporting when it was introduced less than 6 months ago.[90] The industry requires time to analyse and understand any issues with the current comprehensive reporting regime which is new to this market. Commonwealth Bank expects this to take at least two years.

A further area of concern is the cost of implementation. Commonwealth Bank urges the Inquiry to consider the following evidence that this proposal, if mandated, may lead to fewer organisations offering finance or providing poorer quality loans in the absence of comprehensive borrower data:

- Mandatory CCR is a costly and complex undertaking. All lenders, subject to prescribed disclosures to consumers, have access to default information (negative credit records) when making a loan, which can assist in identifying whether consumers have had previous issues with making loan repayments on time;[91]
- Complexity and cost of reporting are material and will potentially disadvantage smaller industry participants and reduce the pool of lenders. An industry standard provides the framework that credit providers must use to disclose CCR data to credit reporting bodies;
- While CCR data consists of five new types of credit related personal information, in reality a greater quantity of information than this must be provided and a number of processes implemented to comply with the industry standard.[92] This is already a costly and complex compliance task; and

87 *Interim Report*, pages 2-10 to 2-11.
88 Australian Government—Office of the Privacy Commissioner (2007) Submission to the Australian Law Reform Commission's Review of Privacy—Issues Paper 32 Credit Reporting Provisions, 13 April 2007, paragraph 6 on page 77. Accessible online at http://www.oaic.gov.au/images/documents/migrated/migrated/sub-alrc-ip32-credit-reporting-200704.pdf
89 Australian Government—Australian Law Reform Commission (2008) For Your Information: Australian Privacy Law and Practice, ALRC Report 108, August 2008, paragraph 55.89. Accessible online at http://www.alrc.gov.au/publications/55.%20More%20Comprehensive%20Credit%20Reporting/problems-more-comprehensive-credit-reporting
90 The *Privacy Amendment (Enhancing Privacy Protection) Act 2012* made significant changes to the *Privacy Act 1988*, including the introduction of more comprehensive credit reporting. The changes commenced on 12 March 2014.
91 *Privacy Amendment (Enhancing Privacy Protection) Act 2012*, Schedule 2, Credit Reporting, section 21C regarding additional notification requirements for the collection of personal information and section 21D regarding disclosure of credit information to a credit reporting body. Accessible online at http://www.comlaw.gov.au/Details/C2012A00197
92 Australian Government—Office of the Australian Information Commissioner (2013) Credit reporting—what has changed, June 2013. Accessible online at http://www.oaic.gov.au/images/documents/privacy/privacy-resources/privacy-business-resources/Privacy_Business_Resource_3_Credit_Reporting_-_What_has_changed.pdf

- In other developed markets such as the US, UK and New Zealand, where CCR has been introduced, it was a voluntary reciprocal arrangement such that if an organisation chose to provide CCR data it is also entitled to receive it, rather than a mandatory requirement. Commonwealth Bank sees no reason for a different approach to be adopted in the Australian market.[93]

RECOMMENDATIONS

- Voluntary reciprocity under the current CCR regime is the most appropriate approach, consistent with most other developed markets; and
- Mandatory CCR is not supported. An orderly transition will occur over time as organisations upgrade their systems and processes and legal agencies work to ensure unintended consequences are adequately managed.

93 Australian Government—Australian Law Reform Commission, ALRC report 108, op. cit., page 1807, paragraph 55.30, table 55-1 and paragraphs 55.187 to 55.189. Accessible online at http://www.alrc.gov.au/sites/default/files/pdfs/publications/108_vol3.pdf

CHAPTER 7: VERTICAL INTEGRATION

The Inquiry recognises that vertically integrated institutions play an important role in providing competitive products and services in the economy, and seeks further information on the impact of integration on competition; the potential distortion of the way in which mortgage brokers direct borrowers to lenders; and how to limit any adverse impacts of integration.[94]

Vertically integrated institutions are increasingly common across the financial services industry and provide significant benefits to their customers. For example, most banks now have some form of wealth management product and advice,[95] superannuation platforms are increasingly adding asset management or advice subsidiaries,[96] and industry super funds are internalising their asset management[97] and advice.

The Australian financial system's structure has matured to improve its service to customers. The 2014 Index of Economic Freedom, sponsored by the Heritage Foundation and the Wall Street Journal, ranks Australia third out of 183 countries, commenting as part of that overall assessment that 'the open financial sector is highly competitive and well-developed'.[98]

1. CONFLICT MANAGEMENT

Commonwealth Bank acknowledges that vertical integration can result in conflicts. Such conflicts should be considered in the context of the existing regulatory framework. All participants (including vertically integrated institutions) are bound by the same rules with respect to the Future of Financial Advice (FOFA) legislation, which places a number of obligations on advisers and product providers, most notably the duty on financial advisers to act in the best interests of the customer. Commonwealth Bank believes the FOFA legislation is highly robust and affords significant consumer protection.[99]

Real and potential conflicts should be actively managed within institutions via monitoring, supervision and compliance functions with oversight of the regulators.

2. CONSUMER BENEFITS AND ECONOMIES OF SCALE

Vertical integration provides the customer with a wider range of products to meet their needs in one place. It also allows organisations to develop a deeper understanding of their customers, so that they are better able to provide the most appropriate products and services.

Vertically integrated institutions are able to offer the customer the convenience of being able to access a consolidated view of their financial affairs (e.g. ability to see their bank balance and super balance online through their online banking website).

Vertically integrated institutions can also pass on the benefits of economies of scale to their customers through pricing, innovation and technology.

94 *Interim Report*, pages 2-21, 2-115.
95 For example CBA, Westpac, ANZ.
96 For example IOOF, Macquarie.
97 For example Australian Super, UniSuper.
98 The Heritage Foundation and Dow Jones & Company Inc. (2014) 2014 Index of Economic Freedom. Accessible online at http://www.heritage.org/index/pdf/2014/book/index_2014.pdf
99 CEO of FSC, John Brogden (2014) "Consumers are being misled on FOFA—FSC exposes the fact", Media Release on 4 July 2014. Accessible online at: http://www.fsc.org.au/downloads/file/MediaReleaseFile/2014_0703_Consumersarebeingmisled-FOFAthefacts.pdf

3. SAFETY AND STRENGTH

Customers want safety and strength. Commomwealth Bank believes that when markets are difficult or volatile, vertically integrated institutions are better at managing these conditions.

Larger and more diversified institutions have the capacity to invest larger sums on risk management and compliance frameworks, and are subject to more scrutiny in their efforts to do the right thing by customers. They are also safer because they have the financial capacity to stand behind their advice and products.

4. COMPETITION AND CHOICE

A healthy and competitive market needs to provide choice to customers. Vertically integrated institutions can, and should, co-exist with non-aligned providers to ensure customers have the ability to select the provider who is best placed to meet their needs. Commonwealth Bank notes that many independent financial advisers in Australia recommend products issued by conglomerate institutions alongside non-aligned products ensuring healthy competition.

4.1 Vertical Integration in the home loan market

The higher percentage of home loans directed to smaller lenders by mortgage brokers compared to the percentage of loans sourced directly by smaller lenders indicates that integration has not had a negative impact on competition, and has not distorted the way in which mortgage brokers direct borrowers to lenders.[100] The mortgage broker proposition continues to see this channel account for a growing share of all mortgage flows, despite ongoing vertical integration in this sector.

In addition, the increased flow of home loans directed to non-major banks by mortgage brokers is indicative of price competition delivering better outcomes for customers.[101]

RECOMMENDATION

The Inquiry should not propose policy changes that would impact the ability of businesses to structure themselves in a vertically integrated manner.

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100 Mortgage and Finance Association of Australia. Accessible online at http://mfaa.com.au/default.asp?artid=3172&menuid=371
101 Australian Finance Group. Accessible online at http://www.afgonline.com.au/wp-content/uploads/2014/02/AFG-Competition-Index-October-2012.pdf; and http://www.afgonline.com.au/wp-content/uploads/2014/07/Competition-Index-July-2014_.pdf


THE AUSTRALIAN BANKS
ARE AMONGST THE MOST
STRONGLY CAPITALISED BANKS
IN THE WORLD.
COMMBANK CAN.

SECTION 3: SUPPORTING AUSTRALIA'S GROWTH

Wellbeing, Prosperity, Resilience.

> 'Notwithstanding the relatively sound exit of Australia from the financial crisis, future risks to citizens and users of the system will have to be managed over an extended timeframe if confidence is to be sustained and strengthened'
> – David Murray AO, Chairman, FSI[102]

The Australian banking system is critical to securing and enhancing the financial wellbeing of the economy, not only to provide savings and investment functions but also to provide critical lending to support economic growth.

Access to global capital markets is critical to the Australian banks' ability to fund such lending. Commonwealth Bank currently obtains 36% of its total funding from global capital markets.[103] These markets are competitive; market participants assess the relative strength of an individual bank through capital and liquidity levels as well as credit ratings. The strength of the Australian banks has been reflected in their 'AA-' credit ratings.[104] These strong ratings provide maximum capacity and lowest cost funding for the Australian economy. For this reason, any reforms which undermine ratings (such as bail-in of senior debt holders) are concerning.

It is critical that the Australian banks' capital ratios are able to be directly compared with international peers to ensure they are seen to be as strong as they really are when competing for the lowest cost and potentially scarce funding.

A recent global study conducted by PricewaterhouseCoopers (PwC) for the Australian Bankers' Association (PwC Report) showed that the Australian banks are amongst the most strongly capitalised banks in the world. This report determined that Commonwealth Bank has an internationally comparable Common Equity Tier 1 capital (CET1) ratio of 13.98% - the second highest bank in the international study.[105] The other major banks have similarly high CET1 ratios. The PwC Report also examined how Australian banks' capital levels would compare if regulated in other jurisdictions. It found that Commonwealth Bank has a higher CET1 ratio than any of the advanced accredited banks in all of those jurisdictions, namely Canada, Germany, Japan, Singapore, Switzerland and the UK.

During the GFC, the Australian banks were subjected to significant stress and remained resilient. Nevertheless, in line with global reforms responding to the GFC, they have substantially increased their capital levels. Commonwealth Bank has increased its APRA CET1 ratio by 107%.[106] Capital requirements are carefully set by APRA, monitored by both bank management and APRA, and stress-tested using various crisis

102 Murray AO, David (2014), op.cit.
103 Commonwealth Bank Results Presentation for the full year ended 30 June 2014, page 116. Accessible online at https://www.commbank.com.au/content/dam/commbank/about-us/shareholders/pdfs/results/fy14_results_presentation.pdf
104 Commonwealth Bank's long term credit rating from Standard & Poor's and Fitch Ratings. Its long term credit rating from Moody's is Aa
105 As calculated and disclosed in the Australian Bankers' Association: The international comparability of the capital ratios of Australia's major banks, August 2014. Accessible online at http://www.bankers.asn.au/FSI/Papers-and-Reports
106 Commonwealth Bank Results Presentation for the full year ended 30 June 2014, page 61.

scenarios – both idiosyncratic and systemic – to ensure sufficiency. Commonwealth Bank believes that the major banks' capital levels are sufficient to support their activities and the needs of the Australian economy.

The *Interim Report* noted the global debate of whether some banks are too big to fail (TBTF), and whether implicit Government support adds to this perception, particularly in relation to globally systemically important financial institutions (G-SIFIs). Commonwealth Bank believes that the private sector should bear the risk of losses during crises, in particular through informed investment in appropriate securities. However, in extreme crisis situations, the Australian banking system may need support to stabilise both the banking system and the economy. Liquidity support to ensure the funding needs of the economy are met through all periods should be unequivocal from the government and the RBA as the 'lender of last resort' when markets are not functioning.This should not expose taxpayers to risk of loss but ensure that periods of stress do not disrupt economic activity.

In implementing reforms, there is a risk that the economy may effectively 'pre-pay' for a potential banking crisis which may never occur. Commonwealth Bank believes that reforms should improve resilience and reduce Government (taxpayer) risk, without effectively pre-paying for a crisis.

Consequently, to allow the Australian banking system to efficiently support the Australian economy, Commonwealth Bank recommends that:

- Australian banks should publicly report capital ratios only on an internationally comparable basis;
- Australian banks should continue to report any conservative treatments of capital to APRA. This would enable APRA to determine the minimum level of capital to be held by each bank, which would be reflected through a Pillar 2 adjustment;
- Australian regulators should continue to use a principles-based bank supervision framework, enhanced by further stress-testing and development of resolution planning and powers;
- The loss absorbency regime adopted for Australian banks should be comparable to, and no more onerous than, regimes adopted by other developed countries;
- Loss absorbency requirements should be bank-specific, based on the risk profile of an individual bank and established through stress analysis;
- The existing loss absorbency capacity should be used. If a new regime is introduced, loss absorbency could be achieved through the use of hybrid securities (hybrid Tier 1 capital and hybrid Tier 2 capital) and possibly 'Tier 3 capital' securities;
- Bail-in of senior debt holders should not be introduced in Australia;
- Liquidity support to ensure the funding needs of the economy are met through all periods should be unequivocal from the government and the RBA as the 'lender of last resort' when markets are not functioning;
- Australian banks should be allowed additional funding options, including the ability to issue residential mortgage-backed securities (RMBS) through master trusts, and tax-efficient capital securities; and
- The FCS claim threshold should be lowered to $100,000. An ex ante fee should not be introduced.

CHAPTER 8: SUPPORTING THE FUNDING NEEDS OF THE AUSTRALIAN ECONOMY

Access to global capital markets is critical to the Australian banks' ability to fund the growth of the economy. The Australian banks need to be strong and to be seen as strong as they really are when competing for the lowest cost and potentially scarce funding, particularly in relation to their capital levels and credit ratings.

Credit ratings are based on rating agencies' assessment of economic, systemic and bank-specific risks. Bank-specific risks include stability, quality of earnings, levels of risk, and capital and liquidity levels. The strong ratings of the Australian banks reflect in part the strong regulatory environment, strong earnings profile and the conservative management of risk within the banks. The Inquiry should consider how it can support the Australian banking system in relation to each of these factors. Any reforms which undermine ratings (such as bail-in of senior debt holders) are concerning.

1. COMPARABILITY OF THE AUSTRALIAN BANKS' CAPITAL RATIOS WITH INTERNATIONAL PEERS IS CRITICAL

RECOMMENDATION

Australian banks should publicly report capital ratios only on an internationally comparable basis.

A key benchmark for both debt and equity investors is capital. Therefore, it is critical that the Australian banks' capital levels are clear and transparent, and comparable with some international peers.

As a result of conservative treatments of capital applied by APRA,[107] the Australian banks' APRA capital ratios are perceived to be substantially lower than international peers. This is supported by the PwC Report which determined that Commonwealth Bank has an internationally comparable CET1 ratio of 13.98% - the second highest bank in the study.[108] According to the PwC Report, Commonwealth Bank's internationally comparable CET1 ratio is 4.7% higher than the APRA CET1 ratio. The other major banks have similarly high CET1 ratios.

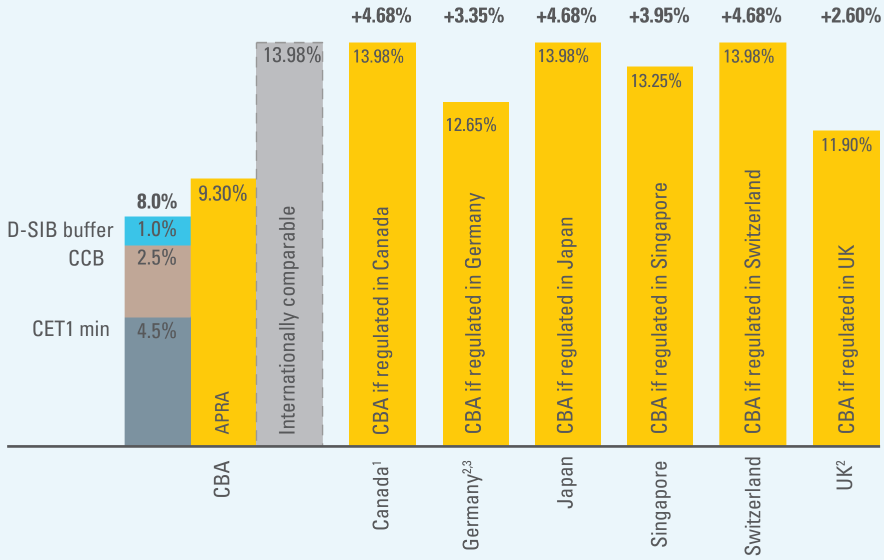
The PwC Report also examined how Australian banks' capital levels would compare if regulated in other jurisdictions. If found that Commonwealth Bank has a higher CET1 ratio than any of the advanced accredited banks in all of those jurisdictions, namely Canada, Germany, Japan, Singapore, Switzerland and the UK.

To address this, Commonwealth Bank and other Australian banks endeavour to report their BCBS standard, internationally comparable capital ratios, as well as APRA capital ratios. Commonwealth Bank also reports how its capital ratios would compare if regulated in other jurisdictions. However, due to complexity, scale and the number of adjustments, the higher capital ratios are viewed by international debt and equity investors with some scepticism.

107 The main conservative treatments of capital applied to the Australian banks by APRA are in relation to: (a) the treatment of equity investments; (b) the treatment of deferred tax assets; (c) the requirement to hold capital for interest rate risk in the banking book; and (d) the application of a high downturn loss given default floor for mortgage portfolios. In addition, there are a number of areas in which other regulators are less conservative than APRA, which benefits international peers in the calculation of their capital ratios. The main areas in this regard are in relation to calculating the risk-weights for corporate loans and the use of slotting for specialised lending. For further information about these, see the *Initial Submission*, Chapter 5 (accessible online at https://www.commbank.com.au/content/dam/commbank/about-us/PDS_PDF/financial-system-inquiry.pdf)

108 As calculated and disclosed in the PwC Report. Accessible online at http://www.bankers.asn.au/FSI/Papers-and-Reports

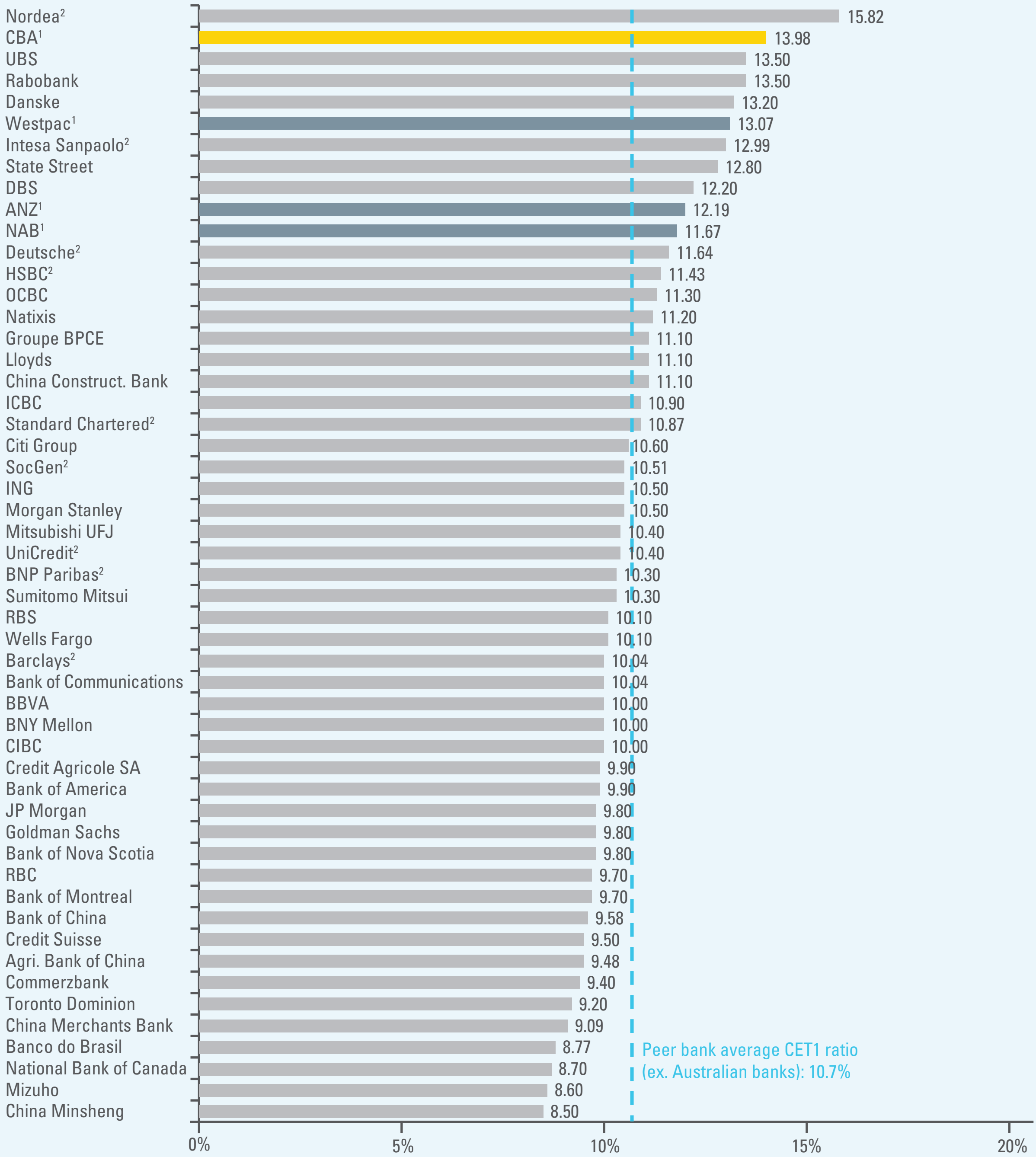
Figure 3: Commonwealth Bank CET1 ratio under various regulatory regimes



Source: Australian Bankers' Association submission to the Financial System Inquiry dated 26 August 2014, incorporating PricewaterhouseCooper's report "The international comparability of the capital ratios of Australia's major banks", August 2014.

1. Does not include the benefit of the Canadian Government guarantee of mortgage insurers, which allows Canadian banks to realise lower risk weights.
2. Since 31 December 2013, UK and some European banks have taken a deduction for accrued expected future dividends (if they are paying dividends).
3. Based on Capitial Requirements Directive IV (CRD IV) as implemented by the European Commission.

Figure 4: Commonwealth Bank CET1 ratio versus peers



Source: Australian Bankers' Association submission to the Financial System Inquiry dated 26 August 2014, incorporating PricewaterhouseCooper's report "The international comparability of the capital ratios of Australia's major banks", August 2014. Assumes Basel III reforms are fully implemented.

1. Commonwealth Bank ratio as at 30 June 2014. Domestic peer ratios as at 31 March 2014.

2. Includes deduction for accrued expected future dividends.

Two recent examples of the difficulty of comparing the Australian banks' capital ratios, and the resulting consequences, are provided below.

CASE STUDY 2: BLOOMBERG MARKETS' INCORRECT USE OF APRA CAPITAL RATIOS

The July/August 2014 edition of the Bloomberg Markets magazine included an article entitled "The World's Strongest Banks 2014", which ranked the world's twenty strongest banks based on Bloomberg's analysis. No Australian bank was included in the list.

Bloomberg compiled the list using Commonwealth Bank's APRA Tier 1 capital ratio at 30 June 2013 of 10.2%, rather than its internationally comparable Tier 1 capital ratio of over 13% at the time. Capital ratios were given a 40% weighting in Bloomberg's methodology and consequently the use of APRA capital ratios led to the misleading conclusion that Commonwealth Bank was not amongst the strongest banks. In contrast, if the CET1 ratios in Figure 4 had been used, it is expected that Commonwealth Bank and the other Australian major banks would have been ranked in the twenty strongest banks.

Bloomberg's magazine is widely read by analysts and investors around the world. This article demonstrates the impact of the lack of comparability of the Australian banks' capital ratios with those of international peers.

CASE STUDY 3: CHART 5.3 OF THE INTERIM REPORT AND INCORRECT INTERPRETATION OF BCBS DATA

The *Interim Report* commented that the Australian banks' actual capital ratios do not appear excessively high, incl uding when compared to countries at a similar level of financial development.[109] Chart 5.3 in the *Interim Report* is used to support this statement, using BCBS data to suggest that Australian bank CET1 and Total Capital ratios are both just below 10%.

Commonwealth Bank disagrees with the interpretation of this data.

The BCBS data is drawn from the results of a Basel III quantitative impact study (QIS) which banks from BCBS jurisdictions complete every six months.

The QIS is based on capital requirements in local jurisdictions with certain items harmonised for comparability. Importantly, risk-weightings are generally based on national requirements and, for the Australian banks, most of the conservative treatments of capital noted in the PwC Report are reflected in the BCBS data. Consequently, the BCBS capital ratios are not comparable across jurisdictions.

109 *Interim Report*, page 3-36

CASE STUDY 3 Continued:

Specifically, the following APRA conservative treatments of capital are retained as well as the impact of conservative modelling:

- Interest rate risk in the banking book; and
- The high downturn loss given default floor for mortgage portfolios applied by APRA.

The PwC Report determined that these differences cause Commonwealth Bank's internationally comparable CET1 ratio to be 4.7% higher than the APRA CET1 ratio.

The PwC Report found that, on average, the Australian banks are at or above the 75th percentile of bank capital relative to the most appropriate comparator set of global banks,[110] not 'in the middle of the range' as suggested by Chart 5.3.

As a result of the conservative treatments of capital, APRA capital ratios cause the Australian banking system and the Australian banks to be perceived to be substantially less well capitalised than international peers. This means that the benefits of holding higher levels of capital, principally lower funding costs, are not fully realised. The perception that capital levels are lower than they really are could lead to higher interest costs for both retail and institutional customers, for example through higher mortgage rates or higher lending margins. Furthermore, there is a risk that banks could ration or permanently reduce their balance sheets in order to maintain, or increase, high capital levels.

DISCUSSION: IMPACT OF HIGHER CAPITAL REQUIREMENTS ON BANK LENDING

If banks are required to hold higher levels of capital, there is a risk that they could ration or permanently reduce their balance sheets in order to meet requirements for increased capital levels. This risk is recognised in research supported by the Bank of England:

> *"Our results suggest that changes in capital requirements affect both capital and lending. In response to an increase in capital requirements, banks gradually increase their capital ratios to restore their original buffers held above the regulatory minimum. Banks also reduce loan growth – in the year following an increase in capital requirements, banks cut (in descending order based on point estimates) loan growth for CRE [Commercial real estate], other corporates and household secured lending. The response of unsecured household lending is shallower and not significant over the first year as a whole. Loan growth mostly returns to normal within 3 years. Finally, initial analysis suggests that banks' responses differ depending on bank size, capital buffers held, the business cycle, and the direction of the change in capital requirements".*[111]

This risk is also recognised in research supported by the European Central Bank:

> *"We found empirical evidence that undercapitalised banks tend to restrict the provision of loans to the economy, as the relatively higher cost of bank equity leads banks to deleverage in order to reach target capital ratios".*[112]

110 PwC Report. Accessible online at http://www.bankers.asn.au/FSI/Papers-and-Reports
111 Bank of England (2014) "Working Paper No. 486, The impact of capital requirements on bank lending", January 2014, page 23. Accessible online at http://www.bankofengland.co.uk/research/Documents/workingpapers/2014/wp486.pdf
112 ibd

2. THE SOLUTION: REPORTING INTERNATIONALLY COMPARABLE CAPITAL RATIOS WITH PILLAR 2 ADJUSTMENTS

RECOMMENDATION

Australian banks should continue to report any conservative treatments of capital to APRA. This would enable APRA to determine the minimum level of capital to be held by each bank, which would be reflected through a Pillar 2 adjustment.

The BCBS capital framework has three pillars: a minimum capital requirement based on risk-weighted assets (Pillar 1); the potential for regulators to add a supervisory adjustment to the capital minimum (Pillar 2); and the discipline of requiring banks to publish their capital ratios (Pillar 3).

The Australian banks' Pillar 1 capital ratios currently include APRA's conservative treatments of capital, which results in the ratios appearing lower than they really are. In contrast, regulators in other jurisdictions allow their banks to perform their Pillar 1 calculation under the BCBS standards, which allows their published Pillar 1 capital ratios to be more readily compared to their peers' ratios. Commonwealth Bank believes the Australian banks should be allowed to do the same.

However, APRA should have the power to determine that individual banks have higher risk profiles and require higher levels of capital. Bank-specific adjustments and other national conservatisms (such as for interest rate risk in the banking book) should be applied through Pillar 2 adjustments. All existing conservative treatments of capital can be retained and APRA can have greater control of capital at the bank level. The Pillar 2 adjustment could be kept confidential as currently required by APRA. Regulators in comparable jurisdictions use this approach as it does not affect the Pillar 1 calculation. Pillar 2 adjustments have been proposed to be more widely used since the GFC, including in Sweden and the UK (see Case Studies 4 and 5).

The Australian banks are currently working with APRA on a project which would allow banks to include their internationally comparable capital ratios in their Pillar 3 reports. However, the primarily reported ratios will continue to be APRA ratios and the internationally comparable capital ratios would not be certified by APRA. As demonstrated by Case Studies 2 and 3, reporting of multiple ratios causes confusion. Therefore, this is not the optimal solution.

CASE STUDY 4: SWEDISH PILLAR 2 ADJUSTMENT

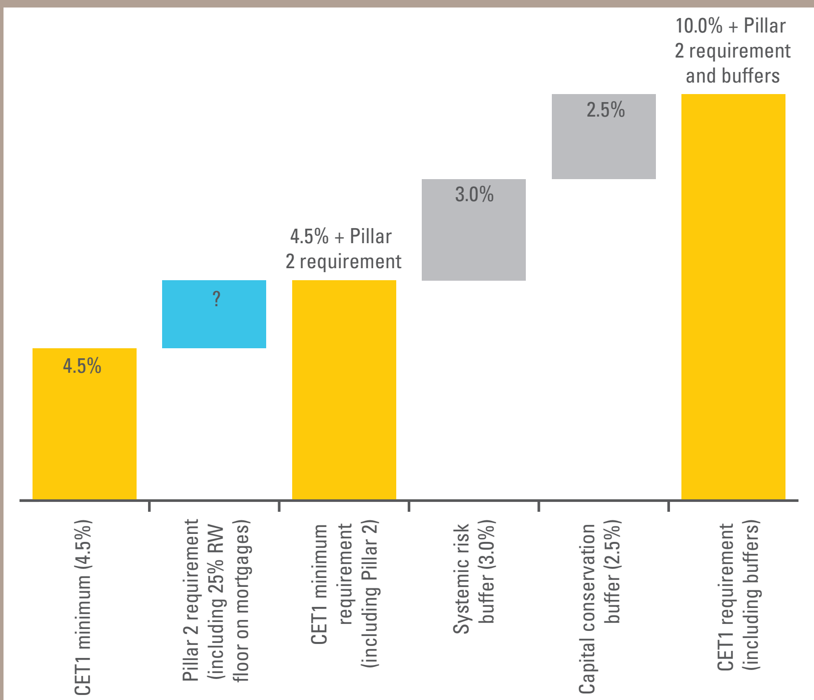
In May 2013, the Swedish regulator (Finansinspektionen) announced the imposition of a risk weight floor of 15% on Swedish mortgages, which is applied through a Pillar 2 adjustment and does not affect reported Pillar 1 capital ratios.

In May 2014, the Swedish regulator announced it was increasing the Pillar 2 risk weight floor on Swedish mortgages from 15% to 25%.

The Swedish approach ensures:

- Swedish banks maintain sufficient capital to cover the conservative requirements of the Swedish regulator;
- the Swedish banking system's strong capital levels are clear and transparent; and
- Swedish banks are not placed at a disadvantage to international peers.

Proposed Swedish CET1 requirements (from late 2014)



Note: Similar to Australia, Swedish banks will also be subject to a counter-cyclical buffer of up to 2.5%

CASE STUDY 5: UNITED KINGDOM PILLAR 2A ADJUSTMENT

In December 2013, the UK Prudential Regulation Authority (PRA) issued a policy statement entitled "Strengthening capital standards: implementing CRD IV, feedback and final rules" which imposes minimum capital requirements which are in addition to Pillar 1 requirements through a Pillar 2 framework. This does not affect reported Pillar 1 capital ratios.

The PRA has divided Pillar 2 into two distinct areas:

- Pillar 2A – risks to the bank which are not captured or fully captured under Pillar 1; and
- Pillar 2B – risks to which the bank may become exposed over a forward-looking horizon.

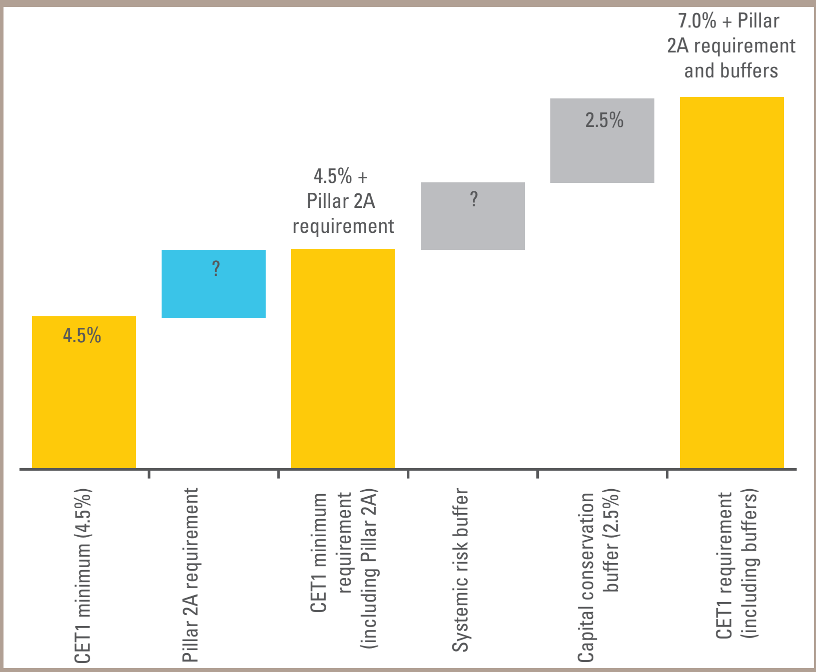
The PRA regards both Pillar 1 plus Pillar 2A requirements as the minimum level of regulatory capital a bank should maintain at all times.

- Pillar 2B is not part of the minimum requirements. Capital held under Pillar 2B is regarded as a capital buffer which helps to ensure that banks can meet the minimum requirements during a stress situation.

The UK approach ensures:

- UK banks maintain sufficient capital to cover the conservative requirements of the PRA;
- the UK banking system's strong capital levels are clear and transparent; and
- UK banks are not placed at a disadvantage to international peers.

Proposed UK CET1 requirements (from 1 January 2015)



Note: Similar to Australia, UK banks will also be subject to a counter-cyclical buffer of up to 2.5%

3. THE AUSTRALIAN BANKS NEED ADDITIONAL FUNDING OPTIONS

RECOMMENDATION

Australian banks should be allowed additional funding options, including the ability to issue RMBS through master trusts, and tax-efficient capital securities.

Commonwealth Bank's *First Submission* recommended that the depth and liquidity of domestic debt markets should be improved, both to reduce the Australian banks' reliance on offshore markets and to provide an alternative source of funding during periods of restricted access or stress. The following recommendations were made:

- Improve the depth and liquidity of domestic debt markets by supporting both supply and demand;
- Support supply through development of the corporate bond market; development of the asset-backed securities (ABS) market, including a critical review of the rules and caps in relation to bank issuance and investments; issuance of debt securities by governments and semi-government entities; longer-term government issuance; and market liquidity assistance from the Reserve Bank of Australia (RBA);
- Support demand through tax system initiatives to encourage debt investment as well as investor education about the risk-return trade-off between fixed income and other asset classes; and
- Enable the banks to issue a range of security types to suit market conditions, including an increase in the permitted level of covered bonds and issuance of RMBS through a viable master trust framework.

The banks should also have the ability to issue tax-efficient capital, such as tax deductible securities, both domestically and offshore to diversify risk and maximise access.

Commonwealth Bank reiterates the importance of these initiatives.

3.1 Residential Mortgage-Backed Securities (RMBS)

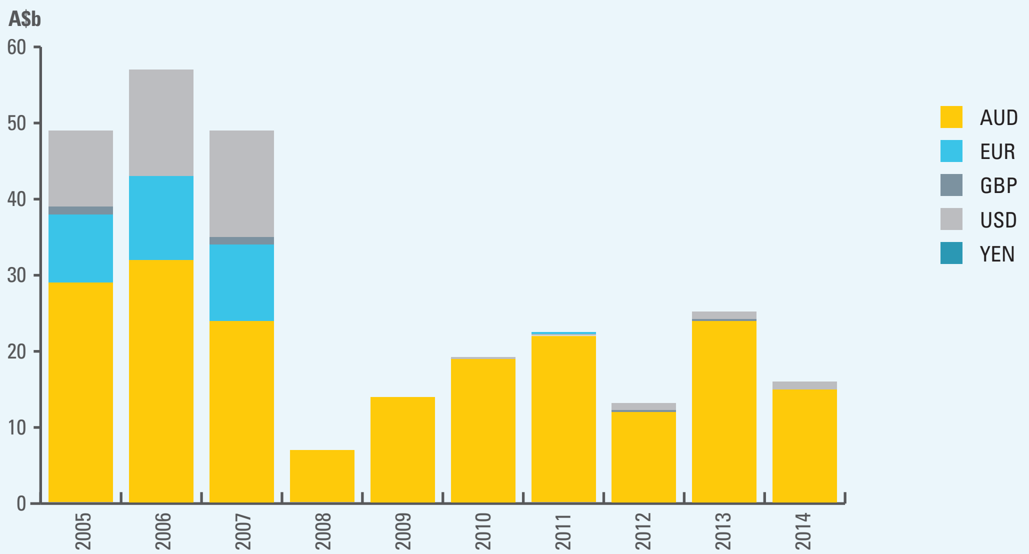
The Inquiry sought views on policy options or other alternatives to provide direct government support to the RMBS markets.

Commonwealth Bank agrees that, as occurred during the GFC, Government support of RMBS markets may be required in certain circumstances for liquidity. Commonwealth Bank endorses the Inquiry's view that, before it recommends future Government intervention in the RMBS markets, it would need to be convinced of a clear market or regulatory failure in the markets.[113]

Current evidence does not support such intervention at this time. While the RMBS markets suffered a significant deterioration in issuance and liquidity activity in the two to three years after the GFC, over the last two years A$ issuance volumes and margins have substantially recovered and are trending back to pre-GFC levels. This has included a material improvement in margins for senior RMBS tranches as well as investor appetite for subordinated tranches, which were more typically retained by issuers/sponsors in the period after the GFC.

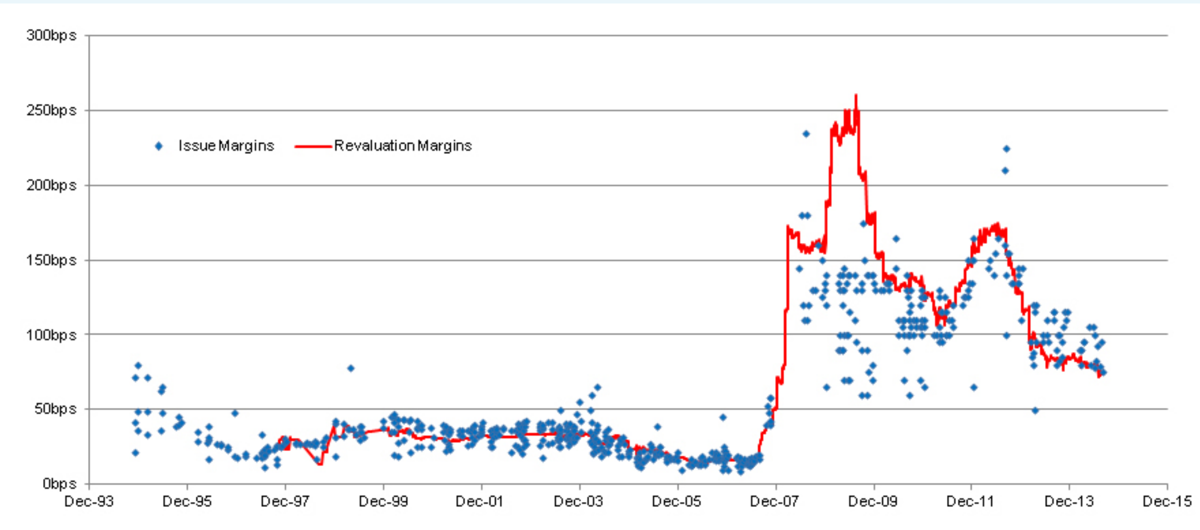
113 *Interim Report*, page 2-15

Figure 5: RMBS issuance 2005 to 2014 (year to date)



Source: Bloomberg and other sources

Figure 6: Australian RMBS margin performance



Source: Macquarie Debt Market Analysis

Commonwealth Bank's *First Submission* discussed a number of mechanisms which could further improve market depth for RMBS issuance. In particular, the Australian banks could more efficiently issue RMBS by issuing multiple tranches through a single 'master trust'. The advantages of a master trust are outlined in Chapter 4 of the *First Submission* and Commonwealth Bank reiterates the importance of this initiative.

CHAPTER 9: PROTECTING THE BANKING SYSTEM AND TAXPAYERS DURING CRISES

During the GFC, the Australian banks were subjected to significant stress and remained resilient. In Commonwealth Bank's view, this was a result of a combination of conservative management of the banks, strong supervision by regulators, and Australia's strong fiscal position. In addition, the Australian Government, in response to large scale government intervention in other markets, took appropriate actions to stabilise both the Australian banking system and the broader economy.

However, Australia should not be complacent and new risks identified through the GFC should be addressed. The *Interim Report* raised one such risk, currently being debated at the global level, as to whether some banks are too big to fail (TBTF) and whether implicit government support adds to this perception. Discussion about TBTF is important, particularly if reliance on government support leads to the moral hazard of greater risk-taking in the knowledge that costs will be borne by the government (taxpayer). Given the smaller number and relative concentration of participants in the Australian banking system, the strength of the banking system as a whole is a critical consideration in these discussions. Any reforms introduced to address the TBTF issue should apply to, and support, all of the banks in the system.

The global debate on the TBTF issue is about how to prevent the need for taxpayer money to support or bail out a failing bank, rather than how to prevent a bank from failing. Many of the reforms responding to the GFC have focussed on reducing the risk of failing, but this risk can never be completely eliminated. Proposed reforms focus on ensuring that losses during crises are borne by the private sector and on banks' capital levels, as this provides loss absorbency capacity from private sector investors. In particular, this has been the focus in relation to G-SIFIs, reflecting the difficulty of implementing other reforms for global banks with large operations in many jurisdictions.

Taking into consideration the Australian banks' capital levels as determined in the PwC Report (see Chapter 8), it is clear that the Australian banks are amongst the most strongly capitalised banks in the world, including amongst G-SIFIs and D-SIBs. As a result, taxpayer risk is minimal. Nevertheless, neither the regulators nor the Australian banks should be complacent about this. Enhancements should be made to stress-testing, and resolution planning and powers.

The *Interim Report* raised several additional proposals which may be considered to address the residual risk and cost of a bank failure. Some of those proposals have significant cost and implications for the banking system, for example bail-in of senior debt holders. These proposals should only be considered after fully implementing those reforms which impose minimal cost and implications, such as those outlined above.

1. THE FIRST LINE OF DEFENCE IS CONSERVATIVE MANAGEMENT OF THE BANKS

The primary responsibility of bank management teams is to manage the bank, while bank Boards have the responsibility of supervising management. This includes managing both day to day, and building a long term sustainable business. The contribution of management and Boards to the Australian banking system's resilience during the GFC has been recognised by APRA and other commentators.[114]

Commonwealth Bank is proud of its 102 years of safe, stable and profitable operations. Commonwealth Bank will continue to be operated by management and the Board with very conservative settings. A conservative management culture at all banks should continue to be encouraged. Risk appetite should be carefully monitored, and appropriate controls and incentives for risk management should be aligned.

114 Australian Prudential Regulation Authority (2014) "Financial System Inquiry Submission", 31 March 2014, page 14. Accessible online at http://fsi.gov.au/files/2014/04/APRA_2014.pdf

Supervisory engagement with management and Boards is then critical to building appropriate communication channels and understanding key risks and issues.

2. THE SECOND LINE OF DEFENCE IS STRONG, INDEPENDENT SUPERVISION BY REGULATORS

RECOMMENDATION

Australian regulators should continue to use a principles-based bank supervision framework, enhanced by further stress-testing and development of resolution planning and powers.

The GFC demonstrated that rule driven frameworks in some jurisdictions fostered a culture of strict compliance without delivering risk management or consumer benefits. For example, following the GFC the UK Government, in consulting on its reforms of the banking sector, observed that "in the run up to the financial crisis, financial supervision relied too much on 'tick-box' compliance with rules and directives, at the expense of proper in-depth and strategic analysis."[115] A number of global reforms responding to the GFC have continued this approach, including the introduction of the Basel III capital, funding and liquidity rules.

However, not all risks can be predicted nor tail risks measured. For this reason, a proactive, even intrusive supervisory approach, is needed to complement the post-GFC regulatory reform agenda to help identify and counter build-up of risks.

2.1 Enhancing stress-testing

Commonwealth Bank supports the use of stress testing to test the resilience of the banks and the adequacy of their capital and liquidity levels. Commonwealth Bank has a dedicated stress testing team, which conducts a number of APRA-designed stress tests as well as internally-designed stress tests. The stress scenarios may be idiosyncratic or systemic, based on domestic or global factors.

In Commonwealth Bank's view, provided the stress scenario is appropriately designed, stress testing is the most effective way of identifying weaknesses in both a particular bank and the broader system (for example, weaknesses in the capital markets and their ability to fund the banking system in a crisis scenario). However, the regulators and the Australian banks should not be complacent about current stress-test results. Stress tests protect taxpayers from the risk of banks failing by ensuring that all parts of the financial system are focused on worst-case scenarios, not just current economic conditions, in determining capital and liquidity levels. These stress tests should include both going concern losses, driven by severe macroeconomic scenarios, and resolution scenarios reflecting systemic stresses. They should take into account the unique composition of the Australian banks' portfolios with high levels of loan-based banking businesses, which result in slower loss emergence and a longer timeframe in which to address issues.

115 HM Treasury (2010) "A new approach to financial regulation: judgement, focus and stability", July 2010. Accessible online at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81389/consult_financial_regulation_condoc.pdf. The Financial Conduct Authority's (FCA) Director of Supervision has also commented that the 'box-ticking' approach of its predecessor (Financial Services Authority) "led to, in effect … the sense that everything will be ok if compliance listens to all the rules and its built around that." – Speech by Clive Adamson, Director of Supervision, FCA, "A sustainable conduct environment", 20 March 2014. Accessible online at http://www.fca.org.uk/news/a-sustainable-conduct-environment

Stress testing in Australia could be enhanced by:

- Extending full stress testing requirements to all financial institutions;
- Soliciting input from industry as to new scenarios to test; and
- Extending stress testing to resolution scenarios.

Commonwealth Bank supports further development of stress-testing capabilities within the RBA and APRA.

2.2 Enhancing pre-planning

The Inquiry sought views on policy options or other alternatives for investing more in pre-planning and pre-positioning for bank failure. Pre-planning includes the concepts of recovery planning and resolution planning.

Commonwealth Bank supports recovery planning. Recovery planning encourages a bank to apply a crisis lens through which to critically review its businesses and to establish appropriate procedures for decision-making in such a situation.

Commonwealth Bank recommends that:

- Recovery plans be refreshed regularly; and
- APRA include as part of the recovery plan requirements a crisis scenario which is used to focus the recovery plan.

Resolution planning which facilitates orderly resolution of a failed bank is also supported. However, Commonwealth Bank understands that the view of regulators is that resolution needs to be led by the regulators rather than the banks because they are the ones who will control a bank at the relevant time. APRA is understood to be currently working on resolution planning.

However, the concept of pre-positioning is different to pre-planning. Commonwealth Bank views ring-fencing as a form of pre-positioning. Both of these are discussed in Chapter 10.

2.3 Enhancing APRA's crisis resolution powers

The Inquiry sought views on strengthening regulators' resolution powers.

Commonwealth Bank was supportive of Federal Treasury's consultation in late 2012 on strengthening APRA's crisis management powers. Continuation of that consultation to determine appropriate legal changes which would facilitate orderly resolution of a failed bank is supported.

Federal Treasury has recently conducted a consultation on changes to legislation needed to give effect to the non-viability trigger event included in hybrid Tier 1 and Tier 2 capital securities. Commonwealth Bank is supportive of these changes as they provide clarity for investors, both on resolution and in normal periods when banks are issuing such securities.

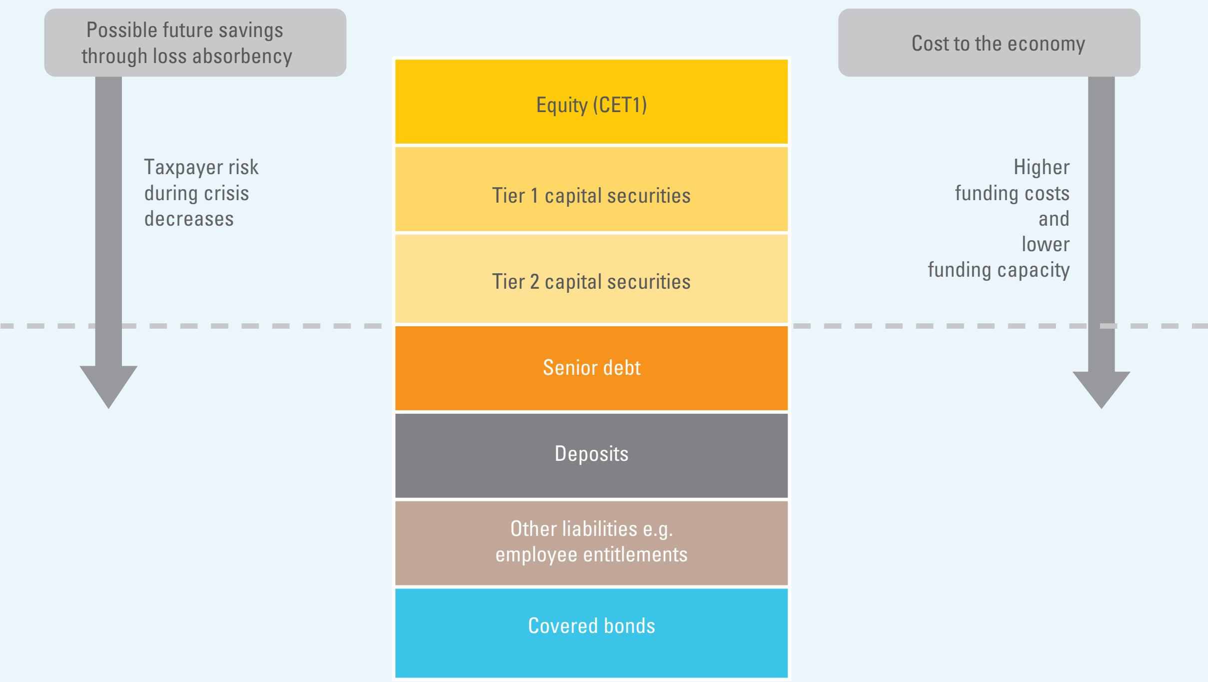
3. THE THIRD LINE OF DEFENCE IS ENSURING THAT BANKS HOLD ADEQUATE LOSS ABSORBING CAPITAL TO PROTECT TAXPAYERS FROM LOSS

RECOMMENDATIONS

- The loss absorbency regime adopted for Australian banks should be comparable to, and no more onerous than, regimes adopted by other developed countries;
- Loss absorbency requirements should be bank-specific, based on the risk profile of an individual bank and established through stress analysis;
- The existing loss absorbency capacity should be used. If a new regime is introduced, loss absorbency could be achieved through the use of hybrid securities (hybrid Tier 1 capital and hybrid Tier 2 capital) and possibly 'Tier 3 capital' securities; and
- Bail-in of senior debt holders should not be introduced in Australia.

There is a delicate balance between optimising current economic growth and protecting against potential future bank failures. Increasing capital levels and potentially introducing bail in of senior debt holders will have an immediate cost to the economy, as they lead to higher funding costs and lower funding capacity. As such, the higher the level of conservatism around possible future crisis scenarios, the greater the prepayment by the Australian economy. This is demonstrated in the following chart:

Figure 7: Hierarchy of loss absorbent capital



Source: Commonwealth Bank

3.1 Strong levels of CET1

While the result of a number of global reforms has been to increase capital and liquidity levels, Australian banks' current capital levels make it extremely unlikely that bank capital levels would fall to the minimum CET1 level in stressed situations, let alone impact the other layers of capital in their capital structure. Commonwealth Bank believes current Australian banks' capital levels make it extremely unlikely that bank capital levels would fall to the minimum CET1 level in stressed situations. This is also supported by the PwC Report's finding that, on average, the Australian banks are at or above the 75th percentile of bank capital relative to the most appropriate comparator set of global banks.

3.2 Increasing hybrid capital requirements

If it is determined that loss absorbing capital is an appropriate mechanism to address TBTF risk, then banks should hold adequate Total Capital (the sum of CET1 and hybrid capital) to ensure loss absorbency in crisis situations. Any new loss absorbency regime adopted for the Australian banks should be comparable to, and not more onerous than, regimes adopted by other developed countries, in order for the Australian banks to be able to compete in global capital markets. Loss absorbency requirements should be bank-specific, based on the risk profile of an individual bank and established through conducting severe stress tests.

Commonwealth Bank believes it is appropriate that equity holders and hybrid holders are subject to bail-in. The primary loss absorbency mechanism as conceived under the BCBS framework and under law, including Australian law, is capital. Equity holders will experience the impact of losses first, because of the perpetual nature of their investment and discretionary nature of dividends. Hybrid investors rank ahead of equity and will be next to experience the impact of losses. In addition, one Basel III reform implemented in Australia is the requirement for hybrid securities to include capital trigger events (hybrid Tier 1 capital only) and non-viability trigger events (both hybrid Tier 1 capital and hybrid Tier 2 capital). If one of these events is triggered, the hybrid securities are automatically converted into equity in the bank or written down. Investors invest in the banks' equity and hybrid securities on this basis and price in this risk.

Australia has adopted the hybrid triggers as a contractual mechanism incorporated in the terms of the securities. Other jurisdictions have adopted the triggers as a statutory mechanism. Commonwealth Bank believes that the contractual mechanism is preferable, as it makes it clear which securities are subject to loss absorbency and the mechanisms.

3.3 Issuing 'Tier 3 capital' securities

Another alternative for consideration is to require the Australian banks to issue securities which are triggered in particular situations in which additional loss absorbency is required ('Tier 3 capital' securities).

'Tier 3 capital' securities would have to be designed and relevant regulatory frameworks developed to support them. One advantage of 'Tier 3 capital' securities over hybrid securities would be the ability to issue them in the form of senior debt with loss absorbency features, rather than as subordinated debt (hybrid securities are required to be issued in the form of subordinated debt), which is more cost efficient.

The amount of 'Tier 3 capital' securities required should be set separately to the bank's capital requirements and be bank-specific, based on the particular risk profile of an individual bank and severe stress analysis. Such a requirement should reflect internationally comparable capital, risk-weightings and stress analysis to avoid the Australian banks being placed at a disadvantage in relation to their total cost of funding compared to international peers. These securities should not be held by other banks (for liquidity or other purposes).

Commonwealth Bank believes that the loss absorbency mechanism should be contractual rather than statutory.

3.4 A sub-optimal reform: bail-in of senior debt holders

In some jurisdictions, it has been proposed that senior debt holders be subject to bail-in, meaning they may be haircut on their investment when a bank experiences financial difficulty.[116] In particular, this has been the focus in relation to G-SIFIs, reflecting the difficulty of implementing other reforms for global banks with large operations in many jurisdictions.

Senior debt holders do not invest in the same risk as equity holders and hybrid holders. For this reason, it is not appropriate that these investors be required to absorb losses. Further, under a bail-in regime, those investors would be forced to price in that additional risk and pricing would widen. Given the high proportion of the Australian banks' funding obtained from global debt markets, this would significantly add to the cost of funds which could lead to higher interest costs for both retail and institutional customers, for example through higher mortgage rates or higher lending margins. Commonwealth Bank believes it would also constrain access to funding, particularly in periods of stress.

Bail-in of senior debt holders is complicated to implement. The limited number of bank holding companies in Australia makes comparison with the US, UK and much of Europe difficult. The interaction of senior debt (and senior debt ratings) with many service provisions, derivatives and other contracts would make continuation of credit and services extremely challenging. In addition, international enforceability is complex. Statutory changes to support this would be significant and costly.

Bail-in of senior debt holders is likely to lead to a downgrade of the Australian banks' credit ratings, which will affect both banks' cost of funds and their access to markets as investors have less appetite for lower-rated investment. Standard & Poor's have indicated that, if the Inquiry recommends bail-in of senior debt and such a recommendation is implemented, then a downgrade of the Australian banks is likely:

> *"We believe that a key issue for ratings of systemically-important banks could be whether the inquiry recommends-and the government adopts-a materially different approach to bank resolutions. In particular, this would include circumstances where there was seen to be a greater appetite for bail-*

116 The haircut can take the form of write down of the value of the investment, or conversion into CET1 or other loss absorbing capital.

in of senior creditors in the event of a banking crisis. Should this occur, and reiterating our previous comments, we may reassess the supportiveness of the Australian government toward the banking system (which, in our current opinion, is high) and reduce the 'government support' benefit currently factored into the ratings of systemically-important banks".[117]

The Canadian regulator recently announced a consultation on the introduction of bail-in of senior debt holders in Canada. On the basis of the announcement, Standard & Poor's revised its outlook on the major Canadian banks from 'stable' to 'negative', and foreshadowed a potential lowering of the banks' ratings within the next two years.

Implementation of a bail-in regime in Australia is likely to lead to a 'flight to quality' away from the Australian banks to higher-rated banks, particularly in periods of stress.

In some jurisdictions, it has been proposed that depositors be subject to bail-in. Commonwealth Bank understands that this is not being proposed for Australia.

4. IN EXTREME CRISIS SITUATIONS, THE AUSTRALIAN BANKING SYSTEM MAY NEED GOVERNMENT SUPPORT

RECOMMENDATIONS

- Liquidity support to ensure the funding needs of the economy are met through all periods should be unequivocal from the government and the RBA as the 'lender of last resort' when markets are not functioning, without exposing taxpayers to risk of loss; and
- The FCS claim threshold should be lowered to $100,000. An ex ante fee should not be introduced.

In extreme crisis situations, the Australian banking system may need Government support. The linkage between the Australian banking system and the broader Australian economy may require this.

The role of the Government in crisis situations should be to stabilise the banking system and thus the economy. Liquidity support to ensure the funding needs of the economy are met through all periods should be unequivocal from the government and the RBA as the 'lender of last resort' when markets are not functioning. This should not expose taxpayers to risk of loss, but ensure that periods of stress do not disrupt economy activity. This is consistent with the experience during the GFC when the Government took action to reopen funding markets. In the future, this will be achieved through a Committed Liquidity Facility (CLF) provided by the RBA, which can be used to source liquidity by pledging high quality assets in periods of stress.

During the GFC, the Government assisted the banking system through the provision of a Government guarantee of the banks' wholesale borrowings and a guarantee of deposits (now implemented as the Financial Claims Scheme or FCS). This was a necessary response to large scale government intervention in other markets, to stabilise both the Australian banking system and the broader economy. The banks paid a fee to utilise the guarantees. Both initiatives were highly successful and did not ultimately lead to any cost to the taxpayer – rather, they provided additional fee income of around $5 billion for the Government at a time when income tax revenues were declining. This emphasises the importance and success of such stabilising initiatives through liquidity mechanisms.

117 Standard & Poor's Ratings Services (2014) "No Impact on Australian Financial Institution Ratings Following the Australian Financial System Inquiry's *Interim Report*", 23 July 2014.

As part of the Basel III liquidity reforms, the RBA will be providing the CLF. The Australian banks may utilise the CLF in periods of stress and, when utilising it, will pay a commercial fee which Commonwealth Bank agrees is an appropriate outcome.

4.1 Financial Claims Scheme (FCS)

The Inquiry sought views on policy options or other alternatives to modify the FCS, possibly including simplification, lowering the insured threshold or introducing an ex ante fee.

The Inquiry has noted that the FCS aims to give depositors confidence in the safety of their money during a crisis, preventing panic and bank runs that may exacerbate the crisis.[118] It is a mechanism to prevent bank runs, not an 'insurance' scheme. Commonwealth Bank supports the FCS for this reason.

However, there is a risk that the FCS, if utilised, may require significant financial resources, which would initially be provided by the Government and which the Government would then need to recover from the failed bank or the rest of the industry. If the recovery was not sufficient, then the Government would realise a loss. Commonwealth Bank believes this risk should be addressed through reducing the scope of the FCS, particularly by lowering the claim threshold to $100,000.

Commonwealth Bank does not support an ex ante fee for the FCS. Any fee could lead to lower deposit rates or higher bank fees for customers, affecting the financial return to investors on an ongoing basis in preparation for a potential crisis which may never occur.

Commonwealth Bank recommends that any deposit protection be optional or on a 'user pays' basis. This would enable the banks to offer two products to investors – a protected product with lower deposit rates or higher bank fees, and a non-protected product with higher deposit rates or lower bank fees. Investors can then choose to invest in particular product, depending on their concern about investing in a particular bank.

118 *Interim Report*; page 3-16

CHAPTER 10: OTHER TOO BIG TO FAIL ISSUES

The composition of the Australian banks' portfolios is unique amongst its international peers, with higher levels of deposit and loan-based banking businesses than markets and securities businesses (see Figure 9).

These loan-based businesses have fundamentally lower risk because losses tend to emerge over a long period. It would require an extraordinary macroeconomic event for the Australian banks to rapidly realise losses to the point of failure from such businesses, compared to peers with substantial markets and securities businesses. This slower loss emergence allows APRA a longer timeframe in which to address issues, enabling a potential recapitalisation rather than inevitably leading to insolvency and resolution.

The unique composition of the Australian banks' portfolios, and the benefits of slower loss emergence, should be taken into account in determining the introduction of additional reforms.

1. THE AUSTRALIAN BANKS' EXPOSURE TO RESIDENTIAL LENDING HAS BENEFITS

Critics have argued that the Australian banks have a heightened risk profile as a result of their exposure to residential lending.

The Australian banks' exposure to residential lending is a reflection of structural issues, particularly lack of opportunities to reduce their exposure through funding mechanisms and lack of additional support for such risk. In contrast, other jurisdictions benefit from deep and liquid securitisation markets in which property exposure is transferred to private sector investors and where there is either Government support for securitisation (for example, through Fannie Mae, Ginnie Mae and Freddie Mac in the US) or lenders' mortgage insurance (for example, in Canada). Structural differences between jurisdictions (including Australia) have been recognised by the International Monetary Fund (IMF):

> *"Housing finance systems differ considerably across countries along a number of dimensions, including product diversity, type of lender, mortgage funding, and the degree of government participation. Some of today's systems are the result of accident or history. Examples are the launch of the current Danish mortgage lending system after the great fire of Copenhagen in 1795, which spurred the need for an organized mortgage credit market to quickly provide funding to build a large number of new buildings; and the German Pfandbriefe (covered bond) system, which dates to 1769 and was heavily influenced by the aftermath of the Seven Years' War. In response to the latest crisis, a number of countries have also taken steps to further strengthen their mortgage market regulations."*[119]

In its most recent report on Fannie Mae, Standard & Poor's noted:

> *"Since its conservatorship in September 2008, Fannie Mae has played an even more integral role, along with Freddie Mac and Ginnie Mae, in providing liquidity to the U.S. residential mortgage market. We estimate the three institutions have combined to guarantee more than 90% of all single-family mortgage issuances during most quarters since the crisis.*
>
> *The lack of private-sector capital to support mortgage-origination activity has contributed to the demand for Fannie Mae's services.*
>
> *In addition to Fannie Mae's single-family credit business ($2.8 trillion book), the firm participates in the multifamily segment, promoting the Administration's affordable housing goals. Fannie Mae's total multifamily guarantee book of business was $203.9 billion as of Sept. 30, 2013, and the company owned or guaranteed 21% of multifamily debt outstanding at June 30, 2013, according to data from the Federal Reserve".*[120]

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119 International Monetary Fund (2011) "Global Financial Stability Report", April 2011, page 115. Accessible online at http://www.imf.org/external/pubs/ft/gfsr/2011/01/

120 Standard & Poor's Ratings Services (2014) "Fannie Mae" 16 January 2014.

Commonwealth Bank notes that exposure to many features of the residential lending market may actually contribute to the ongoing stability of the Australian banks:

- Housing supply in Australia continues to be constrained as strong growth in population, particularly since 2004, has not been met by equally strong growth in housing supply. Housing completions are currently averaging 150,000 a year, similar to the early 1990s when the population was 25% less than the current population. Given rapid population growth, housing investment over the last decade has been relatively moderate compared to other OECD countries;[121]

- Australia is heavily urbanised compared to other developed countries with a preference for low density housing. For example, in Sydney, geographical constraints, limited transport infrastructure and zoning restrictions also add to relative prices;[122]

- Regulators have power to use a number of prudential tools in relation to mortgage lending. This is evidenced by a strong regulatory focus on debt serviceability, quality of collateral and lack of tax deductibility for owner-occupied housing which encourages loan amortisation. In the US market, for example, where tax deductibility is available for owner-occupied housing, amortisation is discouraged and interest-only, negative amortisation and cash-out loans are encouraged. The result is that housing stock in the US is far more leveraged than that in Australia, even during a boom period;

- Home loan products in Australia are prudently structured. Features include full recourse to the borrower, predominance of variable rate mortgages with low prepayment penalty, minimal ‘low doc’ lending and mortgage insurance for higher Loan to Value Ratio (LVR) loans. The combination of the full recourse to the borrower and lack of tax deductibility for owner-occupied loans, which represent the largest proportion of housing stock, tend to give borrowers an incentive to continue payments even under stress. This is

121 International Monetary Fund (2014) Australia: 2013 Article IV Consultation—Staff Report; Press Release; and Statement by the Executive Director for Australia, IMF Country Report No. 14/51, International Monetary Fund Washington, D.C., February 2014. Accessible online at https://www.imf.org/external/pubs/ft/scr/2014/cr1451.pdf

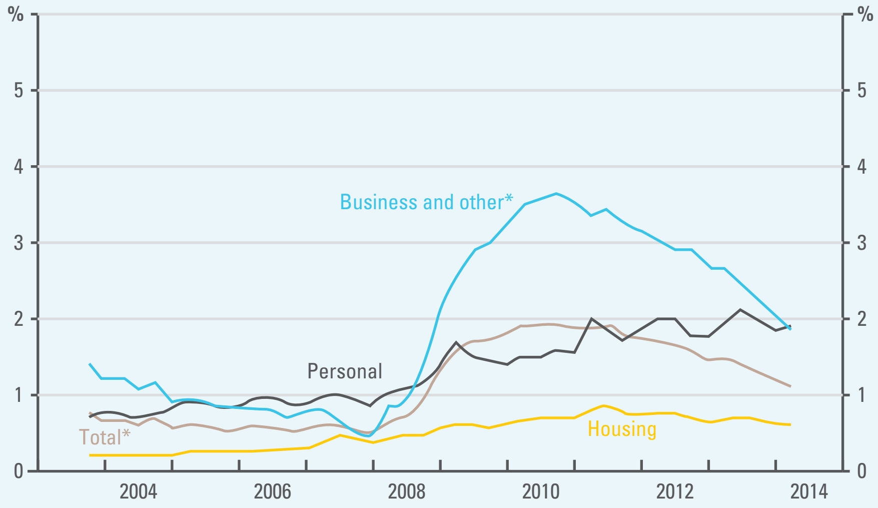
122 ibid

evidenced by Commonwealth Bank's average portfolio LVR of 48%; and

- The mortgage market is largely intermediated, with borrowing dominated by banks that are well rated, well-funded and prudently managed. In Australia, 7.6%[123] of mortgage loans are securitised, as opposed to 22.6%[124] in the US, and the loss rates of each country also differ with Australia experiencing 1.28%[125] versus the US at 5.7%.[126]

Finally, the low risk associated with residential lending exposures supports the Australian banks' ability to borrow in global capital markets and fund the other needs of the Australian economy, including business requirements. Commonwealth Bank agrees with the RBA[127] that the Australian banking system's strength supports a higher share of wholesale funding, easing pressure on the Government to be involved in funding the economy.

Figure 8: Composition of Australian banks' non-performing assets



Source: APRA

2. RING-FENCING WILL BE COSTLY TO THE AUSTRALIAN ECONOMY

The Inquiry sought views on policy options or other alternatives to ring-fence critical bank functions, and whether there are ways to achieve the same benefits without the costs of structural separation.

Commonwealth Bank views ring-fencing as a form of pre-positioning. The key concern is that pre-positioning and ring-fencing may cause businesses to operate sub-optimally, or to incur cost in implementing systems, in preparation for a potential banking crisis which may never occur.

Ring-fencing proposals are usually focussed on separating deposit and loan-based banking businesses from markets and securities businesses, or on separating domestic businesses from offshore businesses. In the Australian context, Commonwealth Bank has two concerns. First, Commonwealth Bank believes history has demonstrated that deposit and loan-based banking businesses are equally as or more likely to fail as other banking businesses. In Commonwealth Bank's view, the better approach is that all businesses, whether they are deposit and loan-based businesses or other businesses, should hold appropriate levels of capital and liquidity and be subject to appropriate supervision. The issues in relation to separating businesses are more critical when a bank experiences financial difficulty or fails, for example when a bank needs to be separated

123 Commonwealth Bank Results Presentation for the full year ended 30 June 2014, page 153. Accessible online at https://www.commbank.com.au/content/dam/commbank/about-us/shareholders/pdfs/results/fy14_results_presentation.pdf
124 ibid
125 ibid
126 ibid
127 Stewart, C. et. al. (2013) Trends in the Funding and Lending Behaviour of Australian Banks, Research Discussion Paper 2013–15, December 2013, Reserve Bank of Australia. Accessible online at http://www.rba.gov.au/publications/rdp/2013/2013-15.ht

into a 'good bank' and a 'bad bank'. Recovery and resolution planning, and appropriate supervision so that the regulator has a good understanding of the relevant businesses, are more appropriate mechanisms to address this.

Secondly, the markets and securities businesses and offshore businesses of the Australian banks are client-focussed, tightly integrated and closely managed. They provide important risk management capabilities for their clients to raise capital from non-bank investors and to hedge the risk of key exposures to interest rates, currencies, commodities and other market variables, enhancing the sustainability of the clients' businesses. The Australian banks' activities in these areas are significantly smaller than many global banks (Figure 9), and are client focused rather than proprietary. This may support an argument that it is easier to introduce ring-fencing now rather than later when the mix has changed. However, the cost of ring-fencing is significant, and the potential to stifle the growth of businesses which support the economy is real, and not justified on the basis of a potential reduction in potential risk.

Figure 9: Comparison of global banks' sales and trading revenues[128]

Bank	Sales and trading revenues as % of total revenues	Jurisdiction	Ring-fencing introduced
BNP Paribas	11	France	Yes
Societe Generale	16	France	Yes
Deutsche Bank	30	Germany	Yes
Credit Suisse	36	Switzerland	Yes
UBS	20	Switzerland	Yes
Barclays	22	United Kingdom	Yes
HSBC	11	United Kingdom	Yes
Royal Bank of Scotland	11	United Kingdom	Yes
Bank of America	15	United States	Yes
Citigroup	21	United States	Yes
Goldman Sachs	42	United States	Yes
JPMorgan Chase	20	United States	Yes
Morgan Stanley	32	United States	Yes
Commonwealth Bank	6	Australia	No
Royal Bank of Canada	9	Canada	No

The cost of ring-fencing offshore businesses may affect the ability of Australian banks to expand offshore,

128 All information (other than in relation to Commonwealth Bank) is sourced from Standard & Poor's Ratings Services (2014) "Delving Deeper Into Global Trading Banks' Risks and Rewards: A Study of Public Disclosures", 22 May 2014. Standard & Poor's focused on the 15 largest trading banks in the world, based on their 2013 financial year disclosures. Commonwealth Bank was not identified as one of those banks. Commonwealth Bank information sourced from Annual Report 2013.

which is counter to the proposals to make Australia a financial centre for the region.[129]

The concerns sought to be addressed by ring-fencing can be addressed by:

- Enhanced supervision of business divisions rather than legal entities – particularly risk appetite, and ensuring there are appropriate controls and incentives for strong risk management and that they are aligned; and
- Prohibitions on activities which cause concern such as proprietary trading.

3. CONGLOMERATE SUPERVISION SHOULD BE REVIEWED

Conglomerate supervision is aimed at reducing potential contagion risk in groups which have both banking and non-banking activities, where losses from non-banking activities may affect the whole group. APRA published its proposed conglomerate supervision framework on 15 August 2014.

Given the Inquiry's deadline, Commonwealth Bank has not been able to consider fully APRA's proposals. However, the recent clarification of Level 2 groups by APRA requires more non-banking subsidiaries to be included in the banking (Level 2) group.[130] Consequently, the continued need for conglomerate supervision should be reviewed.

The potential framework was previously the subject of a consultation process between APRA and the industry. Commonwealth Bank believes this consultation process should continue.

129 Australian Financial Centre Forum (2009) "Australia as a Financial Centre – Building on Our Strengths", November 2009. Accessible online at http://afcf.treasury.gov.au/content/final_report.asp

130 Letter from APRA to all Authorised Deposit-taking Institutions dated 14 May 2014. Accessible online at http://www.apra.gov.au/adi/Publications/Documents/Ltr-to-ADIs-composition-L2-Authorised-Desposit-taking-Institution-group-14-May-2014.pdf

LIST OF RECOMMENDATIONS

COMMONWEALTH BANK RECOMMENDATIONS	PAGE
Set minimum standards for digital delivery of online guidance (consistent with objectives outlined to deliver enhanced consumer outcomes). Such standards should be set by Government in consultation with industry and consumer advocates, and promote technology-neutrality.	28
Establish a taskforce to immediately identify statutory technology anachronisms and prepare a draft amendment bill to address the consequences of rapid digital evolution.	28
Government should work closely with industry on feedback associated with the Treasury discussion paper in relation to the public register.	29
General advice should be renamed as 'sales' or 'product information' and the term 'advice' should only be used in relation to personal advice.	30
Commonwealth Bank believes providers of sales or product information should not be regulated as advice providers where they are not providing financial advice.	30
Emphasis should be placed on building and enhancing financial sector supervisory models that are forward looking and which promote the governance structures, corporate culture and management systems within financial institutions that will enable a firm to operate within prudent strategic settings and respond to emerging systemic risks.	33
Support efforts to improve SME financial literacy and business acumen, including initiatives to provide SMEs with improved access to information and advice on accessing funding to support their business at different life stages.	38
Support efforts to simplify the processes for SME loan applications, particularly through the innovative use of technology and digital channels, and consistent with recommendations on technology-neutrality, simpler disclosure, and accessible financial information.	38
Examine the concept of a government-led SME finance database using government held, but publicly available information, with a centralised SME information portal.	38
Consider the potential for an SME investment fund as a stand-alone entity using funds from government and a broad range of financial services institutions to provide funding to emerging SME businesses. The UK Business Growth Fund (BGF) could offer a useful model.	38
Increase the definitional threshold between SME Retail and Corporate loans, in line with international peers, to at least $1.5 million.	38
Subject to APRA being satisfied, Commonwealth Bank would support measures to assist smaller banks to achieve IRB status, and therefore potentially lower their lending risk weights including: • Relaxation of standardised risk weights (currently set by APRA above Basel minimums); • Removal of the dependency that IRB accreditation is contingent upon approval to use AMA for operational risk and IMA for IRRBB; • Allowing IRB accreditation to apply only to the material portfolios of a bank such as mortgages (i.e. small portfolios could remain as Standardised); and • A Government program designed in conjunction with APRA to assist smaller banks to establish the models and frameworks needed for IRB accreditation.	40
Any changes to APRA's capital requirements would need to satisfy BCBS standards and not undermine systemic stability.	40
Voluntary reciprocity under the current CCR regime is the most appropriate approach, consistent with most other developed markets.	42

ABBREVIATIONS

ABA	Australian Bankers' Association
ABS	Asset-backed Securities
AMA	Advanced Measurement Approach
APRA	Australian Prudential Regulation Authority
BCBS	Basel Committee on Banking Supervision
BWFA	Bankwest Financial Advice Licensees
CCR	Comprehensive Credit Reporting
CET1	Common Equity Tier 1 capital
CFP	Commonwealth Financial Planning Limited
CFSGAM	Colonial First State Global Asset Management
D-SIB	Domestic systemically important bank
FCS	Financial Claims Scheme
FOFA	Future of Financial Advice
FSC	Financial Services Council
GFC	Global Financial Crisis
G-SIFIs	Globally systemically important financial institutions
IMA	Internal Model Approach
IMF	International Monetary Fund
IRB	Internal Ratings Based
IRRBB	Interest Rate Risk in the Banking Book
OAIC	Office of the Australian Information Commissioner
OPC	Office of the Privacy Commissioner
PRA	Prudential Regulation Authority
PwC	PricewaterhouseCoopers
QIS	Quantitative Impact Study
RBA	Reserve Bank of Australia
RMBS	Residential Mortgage-Backed Securities
SME	Small and medium enterprise
SMSF	Self-managed superannuation fund
TBTF	Too Big to Fail

TABLE OF FIGURES

WELLBEING, RESILIENCE AND PROSPERITY FOR AUSTRALIA

FINANCIAL SYSTEM INQUIRY

Interim Report Table
August 2014

INTERIM REPORT TABLE

Commonwealth Bank is pleased to provide its response to the Financial System Inquiry's *Interim Report* observations, options and information requests. The following table cross references relevant sections of the *Interim Report* with Commonwealth Bank's observations in both the *First Submission* and *Final Submission*.

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
GROWTH AND CONSOLIDATION				
COMPETITION				
Observation	The banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral. Banks that use IRB risk weights have lower risk weights for mortgage lending than smaller ADIs that use standardised risk weights, giving the IRB banks a cost advantage.	2-9	19-20	39-40
Policy option	Increase minimum IRB risk weights	2-11	-	40
Policy option	Allow smaller ADIs to adopt IRB modelling for mortgages only	2-11	-	40
Policy option	Provide direct Government support to the RMBS market	2-16	36	56-57
Policy option	Allow RMBS to be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio	2-16	40	-
Policy option	Expand CCR by making it mandatory, adding new fields and/or extending it to SME lending	2-18	-	41-42
Information request	Is integration in the banking sector causing competition issues?	2-21	-	43-44
Information request	Is vertical integration distorting the way in which mortgage brokers direct borrowers to lenders?	2-21	-	44
Information request	If so, what would be the best way to limit the adverse impacts?	2-21	-	44
Information request	Would opening up state- and territory-based statutory insurance schemes to competition improve value for consumers?	2-41	116	-

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
FUNDING				
Observation	Ongoing access to foreign funding has enabled Australia to sustain higher growth than otherwise would have been the case. The risks associated with Australia's use of foreign funding can be mitigated by having a prudent supervisory and regulatory regime and sound public sector finances.	2-45	34-35	-
Observation	There are structural impediments for small- and medium-sized enterprises to access finance. These impediments include information asymmetries, regulation and taxation.	2-61	106-110	35-36
Policy option	Facilitate development of an SME finance database to reduce information asymmetries between lenders and borrowers.	2-68	-	35-36
Information request	To what degree will technological developments resolve issues related to information asymmetries in SME lending?	2-68	-	35-38
Information request	What are the best options to narrow the informational gaps between lenders and SME borrowers?	2-68	109-110	35-38
Information request	What are the impediments to the development of liquid, tradeable claims on infrastructure projects?	2-72	104-105	-
Information request	What effect is the implementation of the Basel III capital and liquidity regimes in Australia expected to have on the cost of funds, loan pricing and the ability of banks to finance new (long-term) loans? How large are these effects expected to be?	2-81	34, 40, 44	-
Observation	Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development.	2-86	34-41	-
Policy option	Allow listed issuers (already subject to continuous disclosure requirements) to issue 'vanilla' bonds directly to retail investors without the need for a prospectus.	2-91	36	-
Information request	As a greater share of the population enters retirement, would the demand for fixed income products increase in the absence of regulation or other incentives?	2-91	39-40	-
Information request	Would the development of annuity-style retirement income investment products encourage the growth of fixed income markets?	2-91	29	-

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
SUPERANNUATION				
Observation	There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system.	2-99	-	18-21
Policy option	Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.	2-114	78	-
Policy option	Replace the three-day portability rule: – With a longer maximum time period or a staged transfer of members' balances between funds, including expanding the regulator's power to extend the maximum time period to the entire industry in times of stress. – By moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach.	2-114	-	15
Information request	Does, or will, MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns? What are the costs and benefits of auctioning the management rights to default funds principally on the basis of fees for a given asset mix? Are there alternative options?	2-115	78	-
Information request	Are there net benefits in tailoring asset allocation to members and/or projecting retirement incomes on superannuation statements?	2-115	85	-
Information request	Is there an undue focus on short-term returns by superannuation funds? If this is a significant issue, how might it be addressed?	2-115	-	16-17
Observation	Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.	2-118	74-75	13-14

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
POST-GFC REGULATORY RESPONSE				
STABILITY				
Observation	During the GFC, significant government actions in a number of countries, including Australia, entrenched perceptions that some institutions are too-big-to-fail. These perceptions can be reduced in Australia by making it more credible to resolve these institutions without Government support.	3-9	47-51	58-70
Policy option	No change to current arrangements.	3-12	47-49	58-60
Policy option	Increase the ability to impose losses on creditors of a financial institution in the event of its failure.	3-12	-	61-64
Information request	Is it possible to reduce the perceptions of an implicit guarantee for systemic financial institutions by imposing losses on particular classes of creditors during a crisis, without causing greater systemic disruption? If so, what types of creditors are most likely to be able to bear losses?	3-12	-	61-64
Policy option	No change to current arrangements	3-13	50-51	59-60
Policy option	Strengthen regulators' resolution powers for financial institutions.	3-13	50-51	59-60
Policy option	No change to current arrangements.	3-14	50	59-60
Policy option	Invest more in pre-planning and pre-positioning for financial failure.	3-14	50	59-60
Policy option	No change to current arrangements.	3-16	-	61-64
Policy option	Further increase capital requirements on financial institutions considered to be systemically important domestically.	3-16	-	61-64
Policy option	No change to current arrangements.	3-18	51	65
Policy option	Modify the FCS, possibly including simplification, lowering the insured threshold or introducing an ex ante fee.	3-18	51	64-65
Information request	What measures could be taken to simplify the FCS with minimal burden on industry, while still ensuring the effectiveness of the scheme?	3-18	51	64-65
Information request	What is an appropriate threshold for the FCS guarantee of deposits?	3-18	51	64-65
Policy option	No change to current arrangements.	3-20	-	68-70
Policy option	Ring-fence critical bank functions, such as retail activities.	3-20	-	68-70
Information request	Is there a case for introducing ring-fencing in Australia now, or is there likely to be in the future?	3-20	-	68-70

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
Information request	If ring-fencing is pursued, what elements should be protected and from what risks? For example, should deposit-taking functions be protected from proprietary trading. Is one of the models used overseas appropriate for Australia?	3-20	-	68-70
Information request	How 'high' should any ring-fence be? Do ring-fenced activities need to occur in entirely separate financial institutions, or could they be part of a group structure that has other business activities? Within a group, what level of separation would be necessary?	3-20	-	68-70
Information request	Are there ways to achieve the same benefits as ring-fencing without the costs of structural separation?	3-20	-	68-70
Policy option	No change to current arrangements.	3-29	52-53	-
Policy option	Establish a mechanism, such as designation by the relevant Minister on advice from the RBA or CFR, to adjust the prudential perimeter to apply heightened regulatory and supervisory intensity to institutions or activities that pose systemic risks.	3-29	52-53	-
Information request	Is new legislation the most appropriate mechanism to adjust the prudential perimeter to respond to systemic risks, or could a more timely mechanism be of benefit? What alternative mechanisms could be used?	3-29	52-53	-
Policy option	Australian regulators make greater use of stress testing with appropriate resourcing.	3-31	-	59-60
Observation	Australia has implemented some aspects of global prudential frameworks earlier than a number of jurisdictions. It has also used national discretion in defining capital ratios. When combined with other aspects of the prudential framework and calculated on a consistent basis, Australian banks' capital ratios (common equity tier 1) are around the middle of the range relative to other countries. However, differences such as those in definitions of capital do limit international comparability.	3-34	42-46	48-55
Policy option	No change to current arrangements.	3-41	25-26	-
Policy option	Maintain the current calibration of Australia's prudential framework.	3-41	25-26	-
Policy option	Calibrate Australia's prudential framework, in aggregate, to be more conservative than the global median. This does not mean that all individual aspects of the framework need to be more conservative.	3-41	25-26	-

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
Information request	Is there any argument for calibrating Australia's overall prudential framework to be less conservative than the global median?	3-41	25-26	-
Policy option	Develop public reporting of regulator-endorsed internationally harmonised capital ratios with the specific objective of improving transparency.	3-42	42-46	48-55
Policy option	Adopt an approach to calculating prudential ratios with a minimum of national discretion and calibrate system safety through the setting of headline requirements.	3-42	42-46	48-55
Information request	Would adopting a more internationally consistent approach to calculating capital ratios materially change Australian banks' cost of accessing funding?	3-43	42-46	48-55
Information request	How would using minimal national discretion distinguish between prudent banks that hold capital as currently defined and those that rely on less loss absorbing capital?	3-43	42-46	48-55
Information request	How might APRA need to adjust minimum prudential requirements to ensure system safety is not altered if using minimal national discretion in calculating prudential ratios?	3-43	42-46	48-55
Observation	To contribute to the effectiveness of the financial system, sound corporate governance requires clarity of the responsibilities and authority of boards and management. There are differences in the duties and requirements of governing bodies for different types of financial institutions and, within institutions, substantial regulator focus on boards has confused the delineation between the role of the board and that of management.	3-44	93	32-33
Policy option	No change to current arrangements.	3-48	93	-
Policy option	Review prudential requirements on boards to ensure they do not draw boards into operational matters.	3-48	93	33
Policy option	Regulators continue to clarify their expectations on the role of boards.	3-48	93	33

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
CONSUMER OUTCOMES				
Observation	The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.	3-56	61-62	25
Policy option	Improve the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators.	3-62	-	25
Policy option	Remove disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using technology and electronic delivery.	3-62	61-62	25
Policy option	Subject product issuers to a range of product design requirements, such as targeted regulation of product features and distribution requirements to promote provision of suitable products to consumers.	3-62	-	25
Policy option	Consider a move towards more default products with simple features and fee structures.	3-62	-	25
Information request	What evidence is there on the effectiveness of financial literacy strategies in enhancing consumer confidence and decision making at particular points in time, and in achieving increasing literacy over the long term?	3-62	97-99	23-24
Observation	Affordable, quality financial advice can bring significant benefits for consumers. Improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower-cost scaled advice.	3-63	82	23
Policy option	No change to current arrangements.	3-69	82	-
Policy option	Raise minimum education and competency standards for personal advice (including particular standards for more complex products or structures, such as SMSFs) and introduce a national examination for financial advisers providing personal advice.	3-69	-	29
Policy option	Introduce an enhanced public register of financial advisers (including employee advisers) which includes a record of each adviser's credentials and current status in the industry, managed either by Government or industry.	3-69	-	29

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
Policy option	What opportunities exist for enhancing consumer access to low-cost, effective advice?	3-72	82	28
Policy option	What opportunities are there for using technology to deliver advice services and what are the regulatory impediments, if any, to those being realised?	3-72	-	28
Policy option	What are the potential costs or risks of this form of financial advice, and what measures could be taken to mitigate any risks?	3-72	-	28
Policy option	Rename general advice as ‘sales’ or ‘product information’ and mandate that the term ‘advice’ can only be used in relation to personal advice.	3-74	-	30
Observation	Technological developments have the potential to reduce insurance pooling. This will reduce premiums for some consumers; however others will face increased premiums, or be excluded from access to insurance. Underinsurance may occur for a number of reasons including personal choice, behavioural biases, affordability, and lack of adequate information or advice on the level of insurance needed.	3-75	112, 114	-
Information request	Does Australia have a problem with underinsurance that warrants some form of policy response? Specifically: – How does Australia compare internationally on adequacy of insurance coverage? – Has the issue of underinsurance been increasing over time? – What evidence and data are available to support a conclusion about our level of underinsurance? – What evidence and data are available to assess whether more granular risk-based pricing will lead to exclusion or further underinsurance?	3-80	112	-
Information request	If warranted, what are possible approaches to lessen the existence of, or mitigate the impact of, underinsurance?	3-80	113-114	-
Policy option	Government to renew consideration of 2009 proposals on product rationalisation of legacy products.	3-87	76-77	-

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
REGULATORY ARCHITECTURE				
Information request	Are there examples where it can be demonstrated that the costs of regulation affecting the financial system are outweighing the benefits?	3-97	74-75	-
Information request	Are there regulatory outcomes that could be improved, without adding to the complexity or volume of existing rules?	3-97	87-94	-
Observation	The regulatory perimeters could be re-examined in a number of areas to ensure each is targeted appropriately and can capture emerging risks.	3-99; xxxiv	67	-
Policy option	No change to current arrangements.	3-106	66	-
Policy option	Introduce a mechanism to allow a heightened level of regulatory intensity to be applied where risk arises outside the conduct perimeter.	3-108	66	-
Observation	Australia generally has strong, well-regarded regulators but some areas of possible improvement have been identified to increase independence and accountability.	3-108	88-90	-
Policy option	Conduct periodic, legislated independent reviews of the performance and capability of regulators.	3-117	92-93	-
Policy option	Enhance the role of Statements of Expectations and Statements of Intent.	3-117	89	-
Policy option	Improve the oversight processes of regulators.	3-117	90-92	-
Observation	During the GFC and beyond, Australia's regulatory coordination mechanisms have been strong, although there may be room to enhance transparency.	3-117	24-25	-
Policy option	Consider increasing the role, transparency and external accountability mechanisms of the CFR: – Formalise the role of the CFR within statute. – Increase the CFR membership to include the ACCC, AUSTRAC and the ATO. – Increase the reporting by the CFR.	3-120	90	-

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
EMERGING TRENDS				
RETIREMENT INCOME				
Observation	The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.	4-8	80	17
Information request	A spectrum of options to achieve the objectives of the retirement income system and position Australia to manage the challenges of having an ageing population: – Maintain the status quo with improved provision of financial advice and removal of impediments to product development.	4-25	82-84	-
Information request	Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.	4-25	82-85	-
Information request	Introduce a default option for how individuals take their retirement benefits.	4-25	84-85	-
Information request	Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).	4-25	84-85	-
Observation	There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.	4-25	83-84	-
Information request	Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products.	4-31	85	-
Policy option	Would deferred lifetime annuities or group self-annuitisation be useful products for Australian retirees? Are there examples of other potentially suitable products?	4-32	83-84	-
Policy option	If part of retirees' superannuation benefits were to default into an income stream product, which product(s) would be appropriate?	4-32	84-85	-
Policy option	Should Government increase its provision of longevity insurance? How would institutional arrangements be established to ensure they were stable and not subject to political interference?	4-32	-	17

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
TECHNOLOGY				
Observation	Technological innovation is a major driver of efficiency in the financial system and can benefit consumers. Government and regulators need to balance these benefits against the risks, as they seek to manage the flexibility of regulatory frameworks and the regulatory perimeter. Government is also well-positioned to facilitate innovation through coordinated action, regulatory flexibility and forward-looking mechanisms.	4-41	56-57	-
Policy option	Amend regulation that specifies using certain technologies with the aim of becoming technology neutral. Amendments should enable electronic service delivery to become the default; however, they should include opt-out provisions to manage access needs for segments of the community.	4-44	58-59, 61-62	26
Policy option	Adopt a principle of technology neutrality, for future regulation recognising the need for technology-specific regulation on an exceptions basis. Where technology-specific regulation is required, seek to be technology neutral within that class of technologies.	4-44	57-59, 61-62	26
Information request	What specific regulatory and legislative requirements should be prioritised for amendment in relation to technology neutrality?	4-45	-	26
Policy option	Establish a central mechanism or body for monitoring and advising Government on technology and innovation. Consider, for example, a public–private sector collaborative body or changing the mandate of an existing body to include technology and innovation.	4-51	60-61	-
Information request	Are there specific areas in which Government or regulators need to facilitate innovation through regulation or coordinated action? For example, by facilitating the development of central utilities?	4-51	60-61	26
Observation	Access to growing amounts of customer information and new ways of using it have the potential to improve efficiency and competition, and present opportunities to empower consumers. However, evidence indicates these trends heighten privacy and data security risks.	4-51	58-60	-
Policy option	Review and assess the new privacy requirements two years after implementation to consider whether the impacts appropriately balance financial system efficiency and privacy protections.	4-55	58-60	-

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
Observations; requests for views on policy options; and requests for information		Page reference	First submission	Final submission
Policy option	Implement mandatory data breach notifications to affected individuals and the Australian Government agency with relevant responsibility under privacy laws.	4-58	66	-
Policy option	Communicate to APRA continuing industry support for a principles-based approach to setting cloud computing requirements and the need to consider the benefits of the technology as well as the risks.	4-58	60-61	-
Observation	The financial system's shift to an increasingly online environment heightens cyber security risks and the need to improve digital identity solutions. Government has the ability to facilitate industry coordination and innovation in these areas.	4-58	59-60	-
Policy option	Review and update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation and progress public–private sector collaboration.	4-63	60	-
Information request	Would a private–public sector discussion forum for strategic issues, such as cyber crisis planning, improve cohesion in implementing cyber security policy? What other mechanisms might assist to improve cohesion or coordination?	4-63	60	-
Policy option	Develop a national strategy for promoting trusted digital identities, in consultation with financial institutions and other stakeholders.	4-70	59	-
Information request	In developing a national strategy, what should be the respective roles, responsibilities and expectations of Australian public and private sector organisations in creating, accepting and maintaining the digital identities used by Australians?	4-71	59	-
Information request	Is there a need for Government to enhance identity authentication by facilitating interoperability standards in areas such as biometrics, enabling better access to Government information or improvements to the Documentation Verification Service	4-71	59	-

FINANCIAL SYSTEM INQUIRY *INTERIM REPORT*			COMMONWEALTH BANK OBSERVATIONS	
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INTERNATIONAL INTEGRATION				
Observation	Government efforts to promote Australia's policy interests on international standard-setting bodies have been successful. Domestic regulatory processes could be improved to better consider international standards and foreign regulation, including processes for collaboration and consultation about international standard implementation, and mutual recognition and equivalence assessment processes.	4-88	25-26, 94	-
Policy option	Improve domestic regulatory process to better consider international standards and foreign regulation — including processes for transparency and consultation about international standard implementation, and mutual recognition and equivalence assessment processes.	4-97	25-26, 94	-
Information request	What changes can be made to make implementing international standards more transparent and otherwise improved?	4-98	25-26, 94	-
Information request	What improvements could be made to domestic regulatory process to have regard to foreign regulatory developments impacting Australia?	4-98	25-26, 94	-
Information request	Are there priority jurisdictions and activities that might benefit from further mutual recognition or other arrangements? What are the identified costs and benefits that might accrue from such an arrangement?	4-98	94	-
Observation	Coordination of Australia's international financial integration could be improved.	4-98	94	-

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