

# **WELLBEING, RESILIENCE AND PROSPERITY FOR AUSTRALIA**

## **FINANCIAL SYSTEM INQUIRY**

**March 2014**



**COMMONWEALTH  
BANK'S SUBMISSION  
IS FOCUSED ON  
IMPROVING THE  
LONG-TERM  
WELLBEING OF  
AUSTRALIANS,  
CONSISTENT  
WITH OUR VISION  
TO SECURE  
AND ENHANCE  
THE FINANCIAL  
WELLBEING  
OF PEOPLE,  
BUSINESSES AND  
COMMUNITIES.  
COMMBANK CAN.**

# TABLE OF CONTENTS

---

## EXECUTIVE SUMMARY

6

## SECTION I: BUILDING ON SOLID FINANCIAL SYSTEM FOUNDATIONS

9

CHAPTER 1: HOW THE FINANCIAL  
SYSTEM HAS SUPPORTED  
ECONOMIC STABILITY

9

CHAPTER 2: A FREE MARKET  
PHILOSOPHY FOR AUSTRALIA'S  
FINANCIAL SYSTEM

24

CHAPTER 3: POSITIONING AUSTRALIA  
FOR A PROSPEROUS FUTURE

27

## SECTION II: SUPPORTING A STRONG BANKING SYSTEM

33

CHAPTER 4: ENSURE SUSTAINABLE  
FUNDING FOR AUSTRALIAN BANKS

34

CHAPTER 5: ENABLE COMPARABILITY  
OF AUSTRALIAN BANK CAPITAL  
RATIOS TO INTERNATIONAL PEERS

42

CHAPTER 6: EMBED A SUPPORTIVE  
OPERATING FRAMEWORK FOR  
AUSTRALIAN BANKS

47

CHAPTER 7: ENSURE AN APPROPRIATE  
FRAMEWORK FOR THE SHADOW  
BANKING SECTOR

52

## SECTION III: PROTECTING AUSTRALIANS IN THE DIGITAL ECONOMY

55

CHAPTER 8: ADJUST SETTINGS  
FOR TECHNOLOGICAL CHANGE

55

CHAPTER 9: ENSURE STABILITY OF  
THE PAYMENTS SYSTEM

63

## SECTION IV: SAFEGUARDING AUSTRALIA'S RETIREMENT WITH A SUSTAINABLE SUPERANNUATION SYSTEM

72

CHAPTER 10: IMPROVE THE EFFICIENCY  
OF THE SUPERANNUATION SYSTEM

72

CHAPTER 11: FUND AUSTRALIA'S  
RETIREMENT

79

## SECTION V: ENHANCING REGULATORY EFFICIENCY

87

CHAPTER 12: IMPROVE EFFICIENCY  
AND ADAPTABILITY OF THE  
REGULATORY SYSTEM

87

## SECTION VI: ADDRESSING OTHER IMPORTANT ISSUES FOR CUSTOMERS

96

CHAPTER 13: IMPROVE FINANCIAL  
LITERACY

96

CHAPTER 14: FUND INFRASTRUCTURE  
DEVELOPMENT

102

CHAPTER 15: IMPROVE ACCESS  
TO CREDIT FOR SMEs

106

CHAPTER 16: ADDRESS  
UNDERINSURANCE AND SUSTAINABILITY  
ISSUES IN INSURANCE

111

## GLOSSARY

117

## TABLE OF FIGURES

119

## APPENDIX

120



**COMMONWEALTH  
BANK BELIEVES THAT  
THE TWO HIGHEST  
PRIORITIES FOR THE  
EVOLUTION OF THE  
FINANCIAL SYSTEM  
ARE CUSTOMER  
WELLBEING AND  
SYSTEM RESILIENCE.  
COMMBANK CAN.**



# EXECUTIVE SUMMARY

An efficient, stable, adaptable and dynamic financial system is essential to enhance the wellbeing of Australians and support the growth of the economy. The Wallis Inquiry reported 17 years ago and much has changed in the economy since then, presenting opportunities and challenges for the financial system. The Financial System Inquiry will consider how to respond to these changes and position Australia for a prosperous future.

The Commonwealth Bank of Australia Group (Commonwealth Bank) has a significant interest in contributing to a successful financial system and recognises the broad impacts it has throughout the economy. Commonwealth Bank is Australia's largest financial institution, serving over 14 million customers. We play an important role in the community as an employer of 51,000 people and as a core investment holding for 800,000 shareholders directly and millions more through superannuation funds. Commonwealth Bank has a track record of being a financial system leader in technology innovation and security. We have been investing over \$1 billion annually in improving our services, security and convenience to customers.

Commonwealth Bank welcomes the opportunity to work with the Inquiry to develop constructive ideas and tangible outcomes to address the financial system's opportunities and challenges.

**We encourage the Inquiry to preserve what has proven to be of most value to the economy, customers and the community and to prepare for future change.**

**Commonwealth Bank has identified what it believes are the three highest priority financial system objectives for the Inquiry's focus:**

- **Support a strong banking system to fund the future growth of the nation.**
- **Harness the potential of the digital economy while protecting customers' information.**
- **Ensure security in retirement for Australians with a sustainable superannuation system.**

These objectives will build on the stability of the financial system since the Wallis Inquiry. The system has been a pillar of support for Australia's uninterrupted economic growth, adapting well as circumstances required. Customers are increasingly satisfied and have a growing pool of superannuation savings. The market is competitive and innovative, as illustrated by the broad choices available to customers and the high rate of investment made for the future. Australia has emerged from the Global Financial Crisis (GFC) in an internationally competitive position.



The strength of a financial system is only properly demonstrated at the weakest point in the economic cycle. Australia's system remained resilient during the GFC but it was appropriate to improve regulatory standards in its wake in order to provide additional strength and stability.

Commonwealth Bank largely supports the changes made and in this submission proposes some enhancements to further improve system efficiency and customer wellbeing. The requirements for participating in the system and maintaining the trust of customers must remain high.

Commonwealth Bank's submission is focused on improving the long-term wellbeing of Australians, consistent with our vision to secure and enhance the financial wellbeing of people, businesses and communities.

**The future for customers will be shaped by the role that technology plays in their lives, the opportunity offered for an ageing population by a growing pool of retirement savings, and the influence of offshore forces.**

The financial system will play a critical role in this future. The Inquiry should consider how to enhance and protect customer wellbeing through all points in the economic cycle and how to ensure that the system remains resilient, particularly during periods of weakness.

Commonwealth Bank's primary recommendations relate to achieving these objectives:

- Increase the depth and liquidity of domestic debt markets.
- Apply consistent, unambiguous regulatory standards to rapidly developing digital financial services to protect customers and system stability.
- Clarify superannuation regulatory boundaries to improve efficiency and support the ability of savers to prepare for a self-funded retirement.

In addition, Commonwealth Bank makes further recommendations on a range of other topics that will influence Australia's future. We identify some topics for additional discussion during the Inquiry:

- Improve the efficiency and adaptability of the regulatory system.
- Assist Australians to make informed financial decisions by increasing the level of financial literacy.
- Review financing options for important segments of the economy, in particular small businesses and infrastructure projects.
- Address issues related to the understanding and affordability of insurance.

This submission is an opportunity to present Commonwealth Bank's views on a range of topics that will require ongoing discussions during the Inquiry. Commonwealth Bank is eager to play a leading role in discussions in order to position Australians for a prosperous future.



**THE FINANCIAL  
SYSTEM HAS  
BEEN A KEY  
PILLAR OF  
THE STRONG  
PERFORMANCE  
OF THE  
AUSTRALIAN  
ECONOMY.  
COMMBANK CAN.**



# **SECTION 1:** **BUILDING ON SOLID FINANCIAL SYSTEM FOUNDATIONS**

## **CHAPTER 1: HOW THE FINANCIAL SYSTEM HAS SUPPORTED ECONOMIC STABILITY**

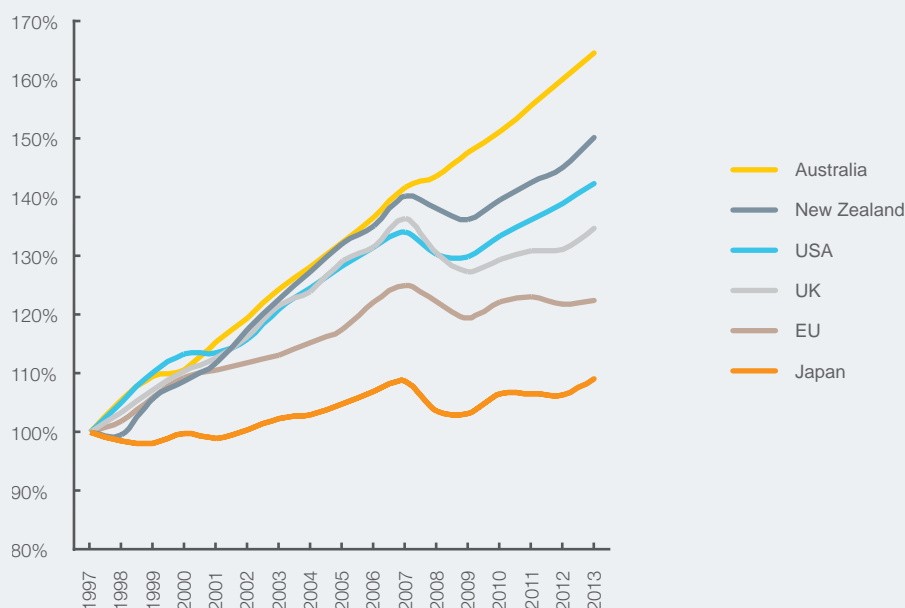
### SUMMARY

- The financial system has been a key pillar of the strong performance of the Australian economy since the Wallis Inquiry, including during the GFC. The financial system is one of the strongest globally and has continually adapted to support Australia's economic growth.
- A strong financial system shares financial and non-financial benefits broadly with multiple sectors of the economy. It competes to serve customers' needs, innovates and generates sustained profitability through the economic cycle to provide capital buffers against downturn.
- History demonstrates that the existence of large and resilient financial institutions can provide the financial strength to support systemic stability during downturns. This protects customers' financial wellbeing and security through the economic cycle.
- The market is competitive. Evidence of this is the large number of market participants and the emergence of new entrants. The pace of product innovation, increased customer satisfaction, improved productivity, margin compression and moderate profitability provide further proof of a competitive market.

## 1. A STRONG FINANCIAL SYSTEM IS IMPORTANT TO THE ECONOMY

The adaptability of the financial system has contributed to the Australian economy growing every year since the Wallis Inquiry reported in 1997. Growth in gross domestic product (GDP) has surpassed most major developed markets over the past 17 years, including during the GFC. Australia has not experienced a recession since 1991 and Australians are wealthier than ever (Figure 1).

**Figure 1: GDP growth of selected countries (indexed from 1997)**



Source: Bloomberg.

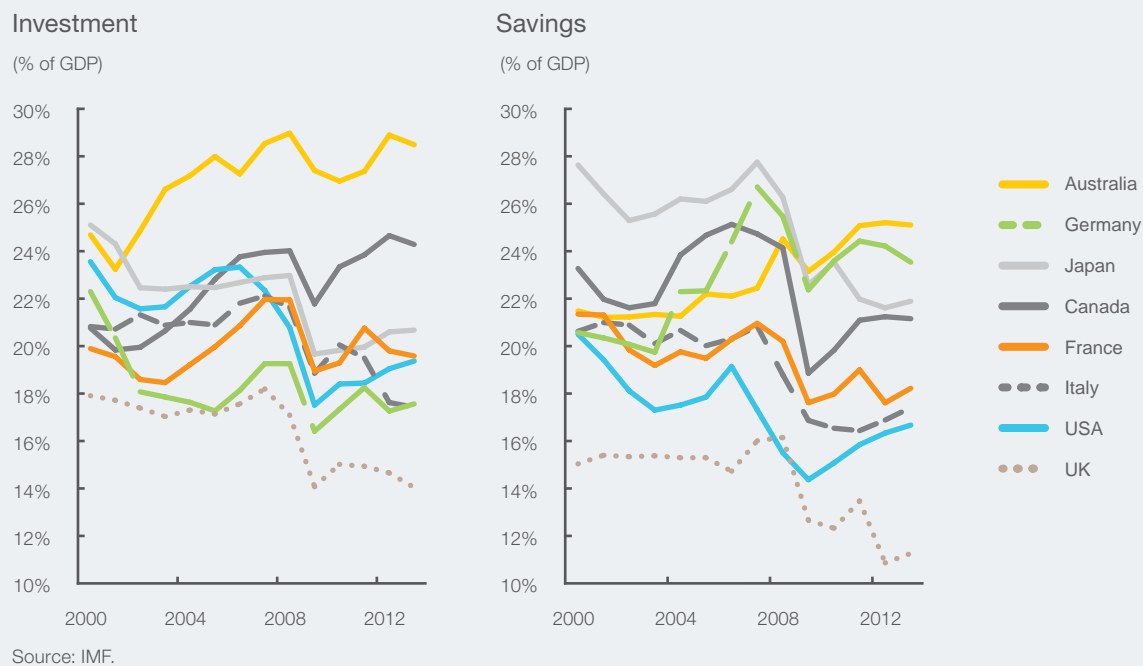
Note: Real GDP growth.

The evolution of the financial system has been a key pillar of Australia's strong performance. The financial system has evolved from a highly segmented market in the 1980s, to the 'Six Pillars'<sup>1</sup> structure during the pre-Wallis era, to the 'Four Pillars' with numerous medium-sized intermediaries Australia has today. The Australian financial system has demonstrated itself to be highly adaptable to support economic growth and to maintain system stability and resilience through the economic cycle. The current market structure creates a strong banking system that can inspire confidence among global investors. Commonwealth Bank continues to support the 'Four Pillars' policy.

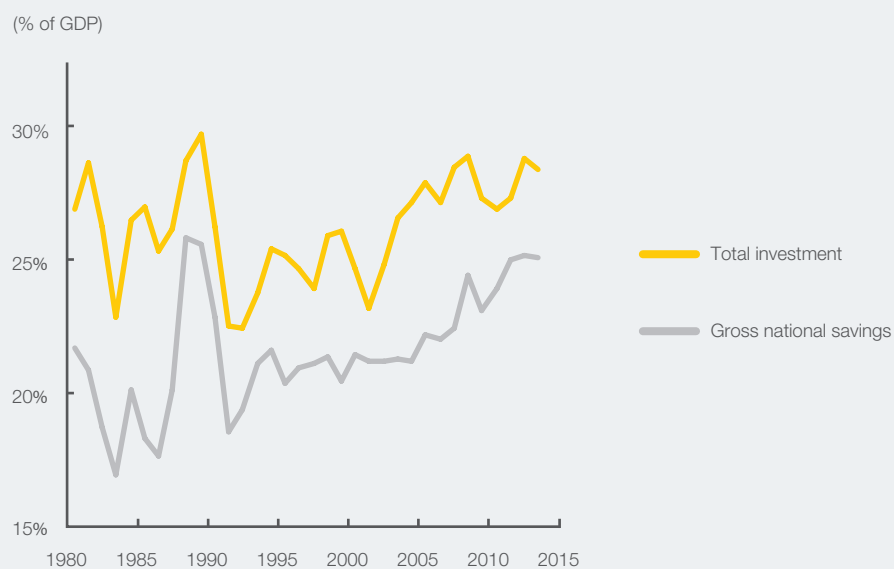
<sup>1</sup> The four largest banks, AMP and National Mutual.

Australia has one of the highest investment rates (as a percentage of GDP) in the developed world (Figure 2). This investment has driven growth, raised living standards and contributed to high government revenues and low government borrowings. Historically, domestic savings levels have been below total borrowing requirements (Figure 3), which has required financial institutions and the markets to finance this shortfall by accessing the savings of the rest of the world.

**Figure 2: Investment and savings of selected countries**

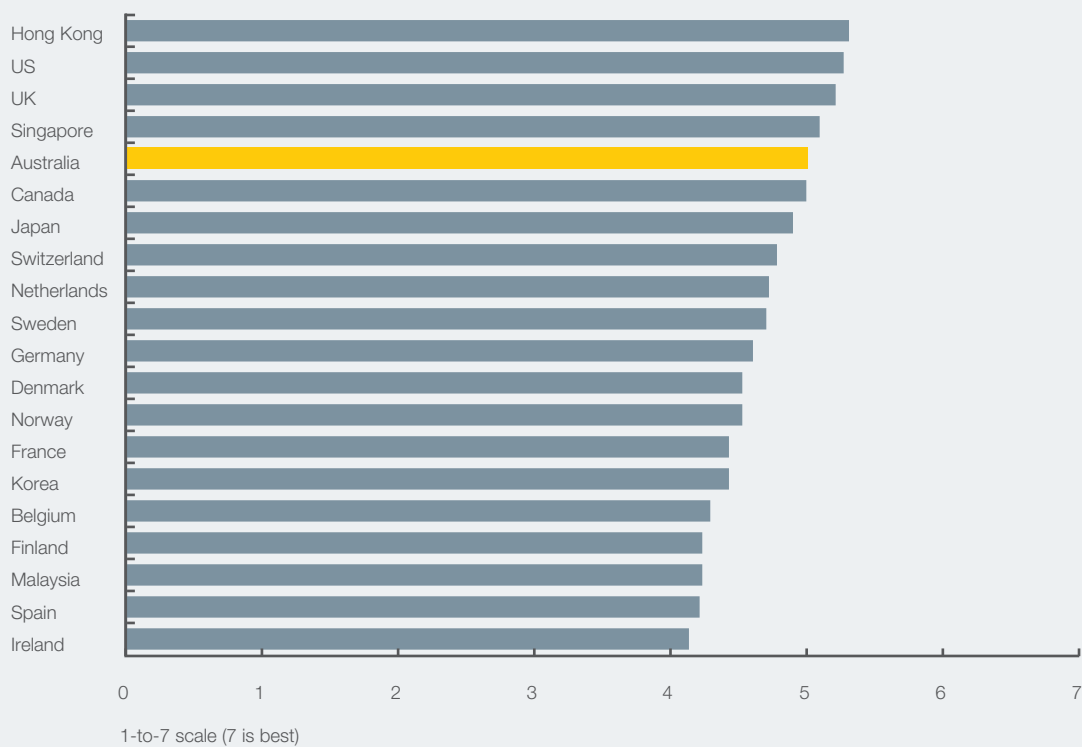


**Figure 3: Australia's savings and investment rates**



Today, Australia has a strong and stable financial system that contributes to the economic growth and welfare of the country. The World Economic Forum ranks Australia fifth among global economies by degree of financial development (Figure 4). Australia scored top ten positions across all financial sector-related pillars.

**Figure 4: Financial development index, 2012**



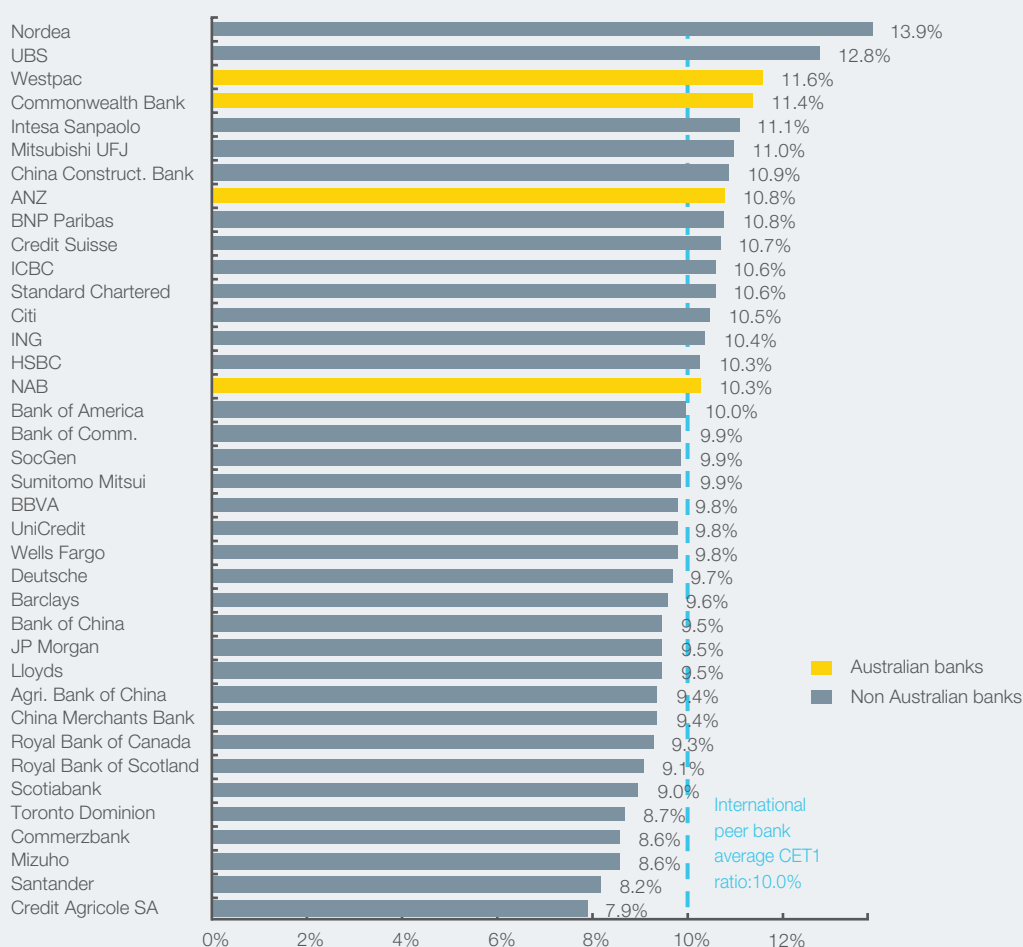
Source: World Economic Forum Financial Development Report.

## 2. THE FINANCIAL SYSTEM SHARES BENEFITS BROADLY

### 2.1 Profitability is important to a sustainable financial system

Profitability is important for sustaining the financial system through the economic cycle. As the economy grows, profitability allows financial institutions to innovate to enhance customers' financial wellbeing and build capital buffers through retained profit. During financially challenging times financial institutions can, if necessary, call upon these buffers of capital to reduce the risk of failure. Prudent management of this profitability has enabled Australia's major financial institutions to be among the best capitalised in the world (Figure 5).

**Figure 5: International peer Basel III Core Equity Tier 1 (CET1) ratio (%)<sup>2</sup>**



Source: Morgan Stanley.

The history of robust performance underpins the confidence of investors globally to maintain and grow their capital commitments to the Australian system. As these investors have benefited from the financial system's sustained growth in dividends and share prices, confidence in the economy has remained high.

Additionally, profitability is one important component of maintaining robust credit ratings and also for meeting investor expectations. Higher ratings enable banks to access more diverse sources of cost-effective funding through the economic cycle. This is especially important for Australian banks which have large relative wholesale borrowing requirements when compared with their international peers. Approximately 13% of Australian bank funding comes from offshore bond investors,<sup>3</sup> some of whom rely on rating agencies for information on companies.

<sup>2</sup> Based on last reported CET1 ratios up to 7 February 2014 assuming Basel III capital reforms fully implemented. Peer group comprises listed commercial banks with total assets in excess of \$700 billion and which have disclosed fully implemented Basel III ratios or provided sufficient disclosure for a Morgan Stanley estimate.

<sup>3</sup> ABS, 'Australian National Financial Accounts', Cat. 5232. Excludes listed and unlisted shares and equities.



## 2.2 A profitable financial system benefits the economy

The benefits from profitable financial institutions have been shared broadly with numerous stakeholders in the economy – customers, employees, suppliers, shareholders, government and the community.

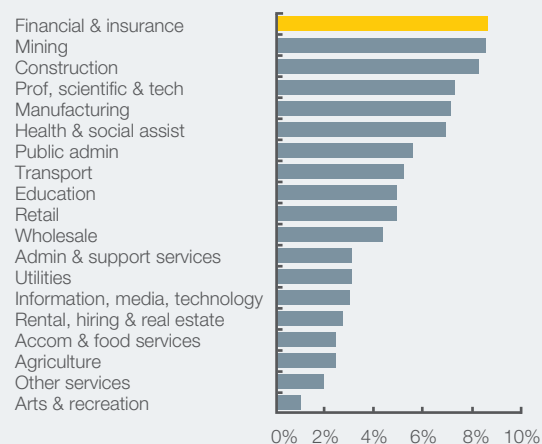
The financial and insurance services sector accounted for the following:

- 8.7% of gross value added in financial year (FY) 2013, making it the largest sector within the Australian economy (Figure 6).
- 37.1% of aggregate listed company dividends in FY 2013.<sup>4</sup>
- 3.6% of total employment in FY 2013 (Figure 6).
- 6.6% of aggregate wages and salaries in FY 2013.
- 11.5% of aggregate profits (defined as gross operating surplus plus gross mixed income<sup>5</sup>) in FY 2013.
- 26% of net corporate tax paid in FY 2012. The financial sector pays a higher effective tax rate than most other sectors of the economy.
- 14% of net Goods and Services Tax liabilities in FY 2012.
- 9% of Fringe Benefit Tax payable in FY 2012.

**Figure 6: Contribution to the economy by industry type**

### Industry Structure

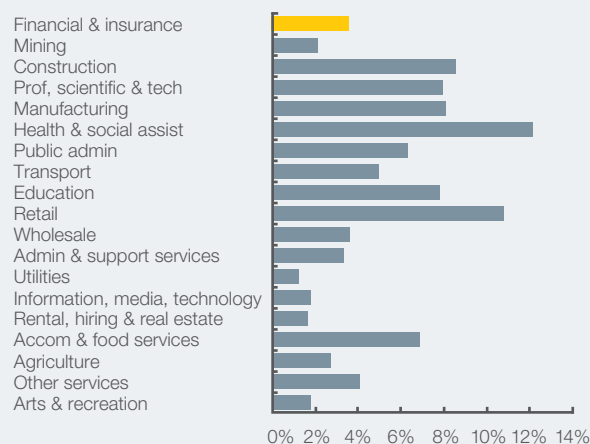
(% of gross value add)



Source: ABS.

### Employment Structure

(% of total)



Source: ABS.

<sup>4</sup> Based on dividend payments from Commonwealth Bank, Westpac, NAB, ANZ, BOQ, Bendigo, Macquarie, AMP, IAG, Suncorp and QBE.

<sup>5</sup> Australian National Accounts' definition. Gross operating surplus and gross mixed income are the excess of gross output over the costs incurred in producing that output before allowing for consumption of fixed capital. Gross operating surplus is operating surplus accruing to all enterprises, except unincorporated enterprises from their operations in Australia. Gross mixed income is operating surplus accruing to unincorporated enterprises.

## Strong contributor to the Australian economy

Commonwealth Bank, as the country's largest financial institution, has played a significant role in the distribution of financial and non-financial benefits:

- **Shareholders:** Commonwealth Bank has approximately 800,000 shareholders who hold shares directly. Approximately 55% of Commonwealth Bank's shares are owned by Australian retail investors. Millions more Australians own shares indirectly through their superannuation funds. These shareholders benefit from Commonwealth Bank being Australia's largest company in terms of dividends declared. Commonwealth Bank paid out 75% of after-tax earnings, totalling \$5.9 billion (including cash payout and dividend reinvestment) in financial year 2013. The financial wellbeing of these shareholders is closely linked to the continued success and profitability of Commonwealth Bank. Based on a market capitalisation of \$120 billion, Commonwealth Bank's shares represent approximately \$66 billion of household wealth. The average share holding is approximately \$70,000 per Australian shareholder.<sup>6</sup>
- **Government:** Commonwealth Bank is the third largest taxpayer in the country. It has delivered consistent income streams to the Commonwealth, State and Territory Governments for many years. It paid approximately \$3 billion in Australian taxes in financial year 2013.
- **Employees and suppliers:** Commonwealth Bank provides substantial stimulus to the economy with approximately \$5.1 billion in salaries paid out to its staff, and \$4.5 billion paid out to providers and suppliers for goods and services in financial year 2013.
- **Loan borrowers.** Commonwealth Bank funded over \$60 billion in new lending in the first six months of financial year 2014.

In support of the wider Australian community, Commonwealth Bank:

- Employs approximately 51,000 people, almost 40,000 of whom are employed in Australia. Commonwealth Bank is one of Australia's largest employers.
- Is committed to maintaining all of its owned functions onshore.
- Provides a wide range of discounted financial services to low income and disadvantaged Australians. These services amounted to savings to the community of more than \$170 million in 2013.<sup>7</sup>
- Provides support for customers experiencing financial difficulty by tailoring solutions to help them return to financial stability and prevent them from receiving poor credit ratings or losing their homes. This program supports over 10,000 customers at any one time.
- Invests over \$40 million each year in the Australian community through teaching financial literacy to students (284,834 students in financial year 2013); collaborating with Indigenous Australians to achieve social, economic and financial inclusion; providing charitable donations and community grants; supporting its staff's participation in volunteering programs; providing sponsorships such as Cricket Australia and Australian of the Year as well as championing social issues such as fighting breast cancer and prostate cancer.
- Serves around 14 million customers,<sup>8</sup> including 11 million depositors and two million home loan borrowers.

**Commonwealth Bank's contribution to Australia and its economy is substantial and continues to grow.**

<sup>6</sup> As at 31 December 2013.

<sup>7</sup> Based on total revenue forgone for Commonwealth Bank.

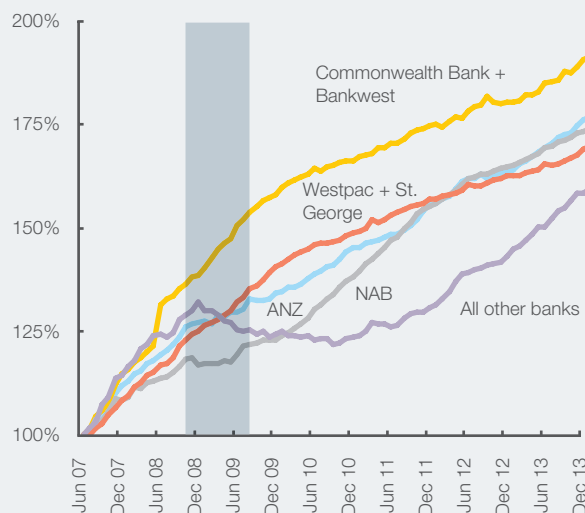
<sup>8</sup> Totals are not mutually exclusive – includes cross product holdings.

### 3. A RESILIENT FINANCIAL SYSTEM IS IMPORTANT FOR ECONOMIC STABILITY

#### 3.1 The Australian financial system is resilient

Financial institutions have supported the growth in customers' needs with growth in their own balance sheets, including during the GFC (Figure 7). Financial institutions have remained resilient through prudent management of their growth, supported by regulators.

**Figure 7: Growth in gross loans and advances (indexed from June 2007)**



Source: APRA.

The International Monetary Fund (IMF)<sup>9</sup> has emphasised that a resilient financial system is important to the economy.

*“Problems in financial systems not only disrupt financial intermediation, but they can also undermine the effectiveness of monetary policy, exacerbate economic downturns, trigger capital flight and exchange rate pressures, and create large fiscal costs related to rescuing troubled financial institutions ... Therefore, **resilient financial systems that are well-regulated and well-supervised are essential for both domestic and international economic and financial stability.**”*

Two differentiating features of the Australian financial system that have been important to its relative resilience through economic cycles are the retention on balance sheet of the majority of originated loans and the onshore location of most critical system infrastructure.

Australia, unlike the US and Canada, does not have a government-sponsored entity that subsidises banks selling the loans they originate for funding purposes. Australian banks have an incentive to be more prudent in their lending practices. Australia has largely avoided the financial stress associated with irresponsible lending practices experienced in countries where balance sheet provision and origination are more separated.

9 IMF, ‘Factsheet on Financial System Soundness’, 19 September 2013, pp. 45-6. Emphasis added.

### 3.2 Large financial institutions are important for maintaining economic stability

#### **A financial system is only as successful as its weakest point in the economic cycle.**

History has shown that the existence of large and resilient financial institutions can provide the financial strength to support systemic stability during downturns.

#### Support for smaller institutions in times of stress

Large financial institutions have been able to absorb smaller financial institutions in times of stress to protect the interests of all stakeholders and to minimise disruptions to the economy. For example, State Bank of South Australia (1991), State Bank of Victoria (1991) and Bankwest (2008) were all absorbed by large banks when they posed a risk to systemic stability.

When Bankwest's funding model came under stress, concern developed about Bankwest's ability to continue as a going concern. The intervention of a large financial institution like Commonwealth Bank with the financial strength to absorb Bankwest was necessary to prevent a potentially disorderly exit and broader contagion, a conclusion supported by Commonwealth Department of Treasury (Treasury)<sup>10</sup> and the Australian Competition and Consumer Commission (ACCC).

*"We spoke to every firm, every bank, that had expressed any interest in acquiring Bankwest—and that included international banks, all the Australian banks, others—and it was quite apparent from our inquiries that if Commonwealth Bank did not buy Bankwest no-one else was likely to buy it ... It would no longer be a vigorous or effective competitor."<sup>11</sup>*

Reserve Bank Governor Glenn Stevens also commented:

*"In the environment that we were in, you do not want an institution with a weakened parent to be sort of twisting in the wind while they work out in the UK what they are going to do ... They found a suitor and, in my opinion, in the conditions of that time ... stability was key."<sup>12</sup>*

This support from a large bank assisted Australia to avoid the serious market disruptions experienced overseas when institutions such as Bradford & Bingley, Northern Rock and Lehman Brothers, relatively small in their own markets, failed. It ensured that Bankwest's \$55 billion loan book, \$37 billion in deposits and 900,000 customers did not require Government support. The state of Western Australia continues to benefit as Commonwealth Bank is committed to retaining the Bankwest brand and maintaining a head office, branches, business centres and key roles in WA.

The transaction also continued the history of banks and regulators working together to avoid systemic consequences noted in the 2004 Davis Report.

<sup>10</sup> Senate Economics References Committee, 'The post-GFC banking sector', Report, November 2012, pp.113-4.

<sup>11</sup> Tim Grimwade, 'Economics Inquiry into Aspects of Bank Mergers', testimony to Senate Standing Committee, 13 March 2009.

<sup>12</sup> Testimony to the Senate Economics References Committee, 13 December 2010.

*“Australia’s experience with restructuring within the prudential regulated sector has been marked more by relatively uneventful mergers and well-managed exits than by spectacular failures and their associated consequences. Australian prudential regulators have played an important role in the process of managing the smooth exit of troubled institutions.”<sup>13</sup>*

These smooth exits assisted by strong Australian banks have allowed the system to continue functioning with minimal disruption. This is in contrast to examples in the UK and the US where large banks that absorbed weaker peers subsequently experienced financial distress themselves (e.g. Bank of America/Merrill Lynch, Lloyds/HBOS).

## Support for Government’s stability measures

Large and resilient Australian banks also demonstrated their willingness to work with Government and regulators on other stability measures for the benefit of the economy. This cooperation on the stability measures necessary during the GFC addressed the liquidity and funding disruptions caused by offshore system failures and avoided the bail-outs of debt and equity holders that occurred in those jurisdictions.

- **Government guarantee of wholesale debt issuance.** In 2008, large Australian banks were continuing to access domestic and offshore funding markets to meet the needs of their customers. However, when the Irish government implemented government guarantees of wholesale debt issuance to protect its failing banks, other weakened financial systems followed and government guarantees soon became the global standard. The Reserve Bank of Australia (RBA) sought to avoid Australian banks being placed at a relative disadvantage:

*“The arrangements promoted financial system stability in Australia ... [and] ... ensured that Australian banks were not placed at a disadvantage compared with international competitors that could access similar government guarantees on bank debt.”<sup>14</sup>*

The RBA’s actions would not have been necessary if government guarantees had not been implemented offshore. Banks paid and continue to pay a fee for what acted as liquidity support of solvent Australian banks in a disrupted international funding market. This contributed cumulative industry fees to the Government of \$4.4 billion (in the period up to January 2014). No claims have been made on the guarantee and as a result Australian taxpayers have not borne any cost. The Government raised additional revenue during a challenging fiscal period and customers benefited from limited increases in borrowing costs. The net benefit was retained in Australia.

- **Financial Claims Scheme (FCS) deposit guarantee.** The FCS was introduced in 2008 to relieve funding pressures on smaller banks, which were experiencing deposit outflows to the major banks in a ‘flight to quality’ by depositors. Commonwealth Bank benefited from these deposit flows in the early stages of the GFC in the form of \$70 billion of new deposits.<sup>15</sup> However, Commonwealth Bank supported the introduction of the FCS as it stabilised the deposit market and assisted in protecting smaller banks from severe stress. No claims have been made on the FCS.

<sup>13</sup> ‘The Study of Financial System Guarantees’, March 2004, p. 10.

<sup>14</sup> Australian Government website, ‘About the Scheme – Guarantee Scheme for Large Deposits and Wholesale Funding’, (<http://www.guaranteescheme.gov.au/>).

<sup>15</sup> July 2007 to December 2008.



## 4 CUSTOMERS BENEFIT FROM A COMPETITIVE MARKET

### 4.1 Context

**The Australian financial system is competitive.** Competition in the financial sector delivers benefits to customers. These include access to a broad range of financial products and services from a variety of providers, high levels of customer satisfaction, technology and product innovation, improved productivity and competitive pricing. In recent years, regulatory changes to enhance the ease of switching between providers (e.g. removal of mortgage exit fees) have enabled customers to more easily harness the benefits of competition.

### 4.2 The Australian financial system is competitive

Customers have a broad choice of providers within the Australian financial services market. There are approximately 170 Authorised Deposit-taking Institutions (ADIs) and more than 100 insurers and friendly societies.<sup>16</sup> Many strong institutions compete in each major product segment (Figure 8).

**Figure 8: Examples of players by product segment (excluding the four major banks)**

Segment	Product	Key players (Excluding the four major banks)			
Retail	Home Loans	Suncorp	ING	Bendigo and Adelaide Bank	Bank of Queensland
	Deposits	Bendigo and Adelaide Bank	Macquarie Bank	Suncorp	ING
	Credit cards	Citigroup	HSBC	Bendigo and Adelaide Bank	Macquarie
Business and Corporate	Business and corporate lending	Mitsubishi UFJ	Rabobank	Sumitomo Mitsui Banking Corporation	Bendigo and Adelaide Bank
	Corporate syndicated lending	HSBC	Sumitomo Mitsui Banking Corporation	RBS	Mitsubishi UFJ
	Equities	Citigroup	Deutsche	UBS	Macquarie
Wealth management	Life insurance	AMP	TAL	AIA	Suncorp
	General insurance	QBE	IAG	Suncorp	Allianz
	Retail funds management	AMP	Macquarie	IOOF Group	Mercer

Source: APRA, Bloomberg, IRESS, PwC report Insurance and Figures Australia 2013, Commonwealth Bank analysis.

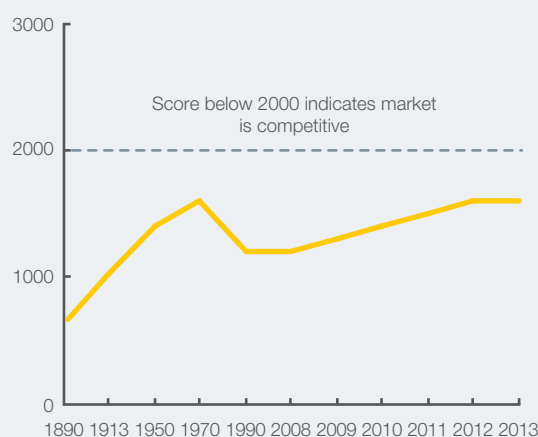
<sup>16</sup> Regulated by APRA as at 30 June 2013. Source: APRA.

Although the Australian banking market is relatively concentrated, it remains competitive as indicated by the Herfindahl-Hirschman Index (HHI) (Figure 9), an index commonly used by the OECD<sup>17</sup> and ACCC.<sup>18</sup> The HHI for Australia at 1600 remains below the threshold of 2000, indicating the market is competitive<sup>19</sup> and is broadly in line with other developed markets.<sup>20</sup> By global standards the level of concentration is consistent with the size of the economy (Figure 10).

**Figure 9: Australian banking Herfindahl-Hirschman concentration index**

Herfindahl-Hirschman Concentration Index  
(For banking assets)

(0 = perfect competition, 10,000 = monopoly)

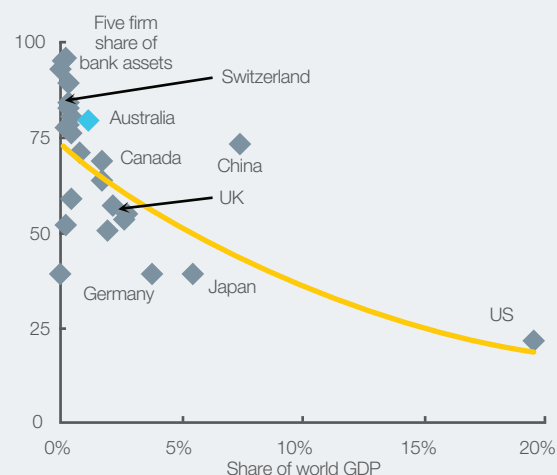


Source: OECD, APRA, Commonwealth Bank.

Note: HHI is a measurement used to understand the level of concentration that exists within a market or industry. It is commonly used by competition regulators including the ACCC when considering mergers. The rise in the index from 2008 resulted from the acquisition of Bankwest by Commonwealth Bank and St George by Westpac.

**Figure 10: Relationship between financial system concentration and size of the economy**

Concentration & Economic Size  
(advanced economies)



Source: Commonwealth Bank; Liu & Mirzaei 'Industrial growth: Does bank competition, concentration and stability constraint matter?', Brunel University WP 13-23, September 2013.

The following key indicators further support a competitive financial system for Australia.

- Dynamic and actively sought market share across key products (e.g. home loans, retail deposits, business loans).<sup>21</sup>
- The emergence of well-resourced new players in key product categories (e.g. Macquarie through Yellow Brick Road in home loans).
- The returns on equity (RoE) of the larger banks are moderate relative to non-banking peers with comparable market capitalisations. Commonwealth Bank has the second largest market capitalisation amongst the ASX 100 companies but ranks only 27th for RoE (and 77th for return on assets). RoEs have declined across the industry since 2008.

17 The HHI is noted by the OECD as a widely used measure for market structure in empirical work. OECD, 'Policy Roundtable - Competition, Concentration and Stability in the Banking Sector', 2010.

18 The HHI is used in assessing the impact of merger on market concentration. ACCC, 'The 2008 Merger Guidelines', 2008. Where that index is below 2000, competition regulators typically do not see market concentration as raising significant competition issues.

19 Each of the key retail banking product markets delivers HHI scores of less than 2000. Deloitte Access Economics, 'Competition in Retail Banking', 2014.

20 Australia = 1600, US = 1400, UK = 1300, Korea = 1300, China = 1800.

21 For example, Macquarie has increased its market share in home loans through Yellow Brick Road by ~5x times (from 0.22% in January 2002 to 0.98% in January 2014) and Bank of Queensland has increased its market share in household deposits from 0.90% in January 2002 to 2.62% in January 2014. Based on APRA data.

### 4.3 A competitive market benefits customers

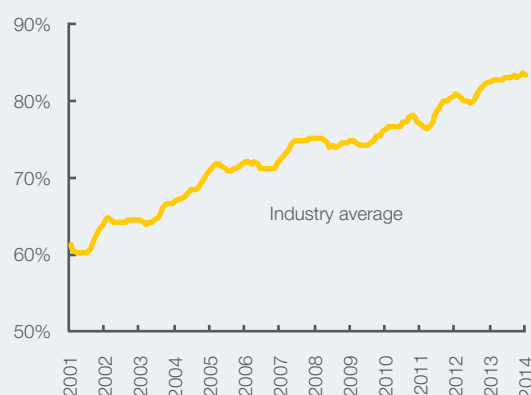
In addition to broad access and choice of financial products and providers, Australian customers further benefit from active competition.

- **High levels of customer satisfaction.** Australian banks and financial institutions have increasingly sought to differentiate their proposition through customer service. As a result, customer satisfaction has increased (Figure 11, Figure 12).

**Figure 11: Retail banking sector industry average customer satisfaction**

% satisfied

("Very Satisfied" or "Fairly Satisfied")



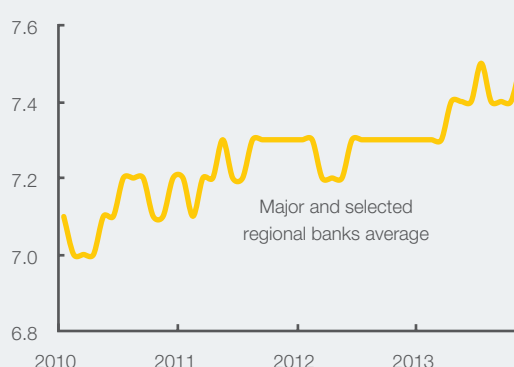
Source: Roy Morgan.

Note: Roy Morgan Research Retail Main Financial Institution (MFI) Customer Satisfaction. Australian population 14+, % 'Very Satisfied' or 'Fairly Satisfied' with relationship with that MFI. 6-month rolling average for 'Total Banks'. Refer to End Note for the full list of 'Total Banks'.

**Figure 12: Average business banking sector customer satisfaction for major and selected regional banks**

Average satisfaction score

(0 = extremely dissatisfied, 10 = extremely satisfied)



Source: DBM, Business Financial Services Monitor.

Note: DBM Business Financial Services Monitor (March 2010 to January 2014), weighted average satisfaction rating of Australian business customers' MFI, for major and selected regional banks,<sup>22</sup> using an 11-point scale where 0 is Extremely Dissatisfied and 10 is Extremely Satisfied, 6 month rolling average. NB DBM's Business Customer Satisfaction information was first available to Commonwealth Bank in 2010.

- **Technology innovation.** Australian financial institutions invest in innovation to continually improve their efficiency and their delivery of products and services that meet customers' needs. The Wallis Inquiry report noted:<sup>23</sup>

*"The efficiency of the financial system affects every business and individual in the nation. There are very large efficiency gains and cost savings which could be released from the existing system through ... continuing developments in technology and innovation. Markets can deliver these outcomes where competition is allowed to thrive and where customers have confidence in the integrity and safety of the system."*

Australian financial institutions make significant investments in competing to serve customers better. For example, Commonwealth Bank has invested over \$1 billion in each financial year since 2008, much of which is in technology innovation.

Updated technology systems benefit customers through improved functionality, such as real time payments and every day transaction processing, and are likely to accelerate future innovation in the sector. Commonwealth Bank completed its Core Banking Modernisation program in October 2012 and regularly releases innovative customer offerings. For example: Tap & Pay (in partnership with Samsung and MasterCard), the world-first application of near field communications (NFC) technology in contactless payments; the new CommBank app; CommBiz Mobile; Kaching; and MyWealth, an online hub to help self-managed investors build and manage their own wealth.

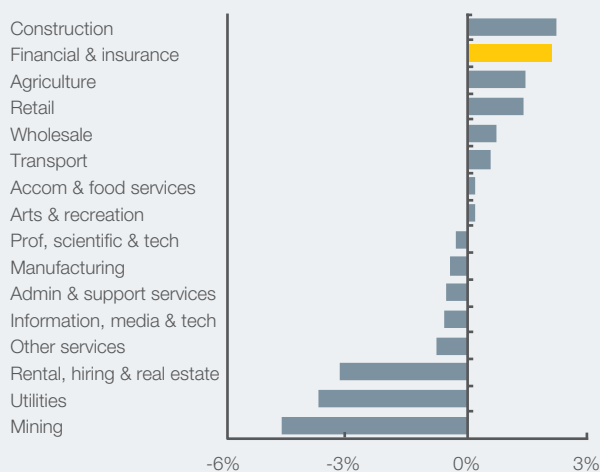
<sup>22</sup> Commonwealth Bank, Westpac, NAB, ANZ, St. George, Bankwest, Bendigo, Bank of Queensland, and Suncorp.

<sup>23</sup> 'Financial System Inquiry', 1997, p. 2.

- **Product innovation.** The industry has grown its offering of attractive products that benefit consumers. For example, home loan offset accounts (enable savings to offset home loan interest), rewards transaction accounts (earn rewards not only through spending but also saving) and lifetime growth annuities (provide downside protection while retain access to growth).
- **Improved productivity.** Competition and innovation in the Australian financial sector have contributed to improved productivity, which benefits customers. Financial institutions have delivered the second highest growth in productivity over the past decade among domestic sectors (Figure 13) and are among the most productive in the world (Figure 14).<sup>24</sup> The improved productivity has lowered financial transaction costs for the economy (Figure 15).

**Figure 13: Multifactor productivity growth (annual growth over 10 years to 2012/13)**

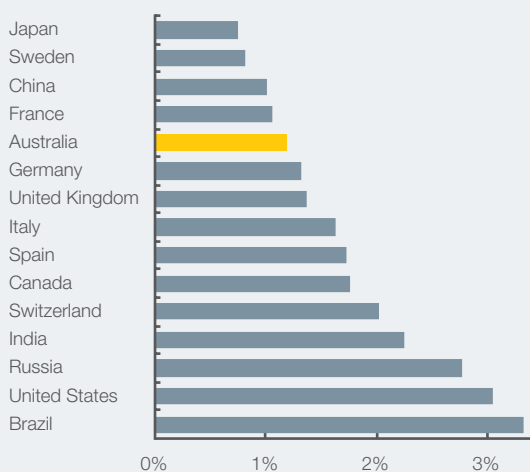
Annual productivity growth



Source: ABS.

**Figure 14: Cost to asset ratio of major banks, 2012**

Cost to asset ratio

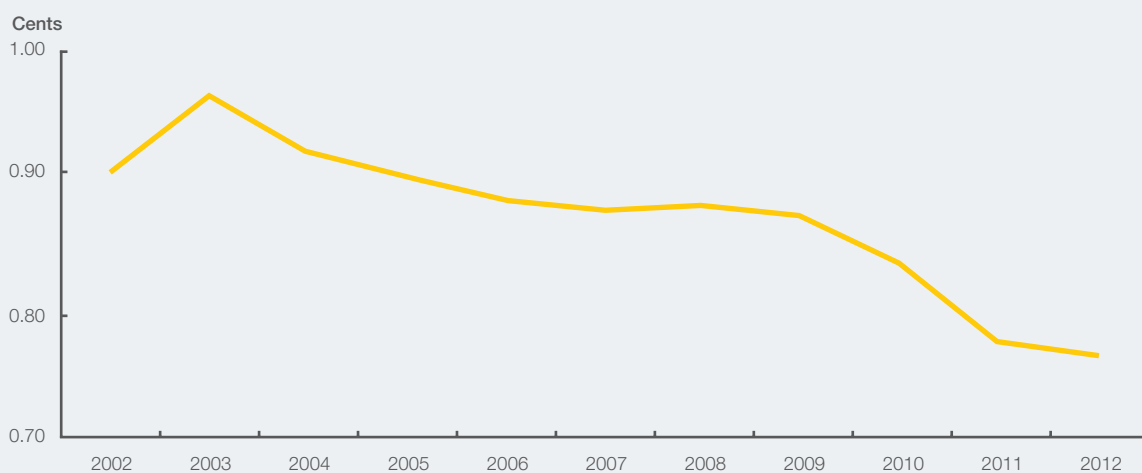


Source: BIS 83rd Annual Report.

Note: Cost includes personnel and other operating costs.

**Figure 15: Bank fees**

Bank fees (in cents) per dollar of GDP

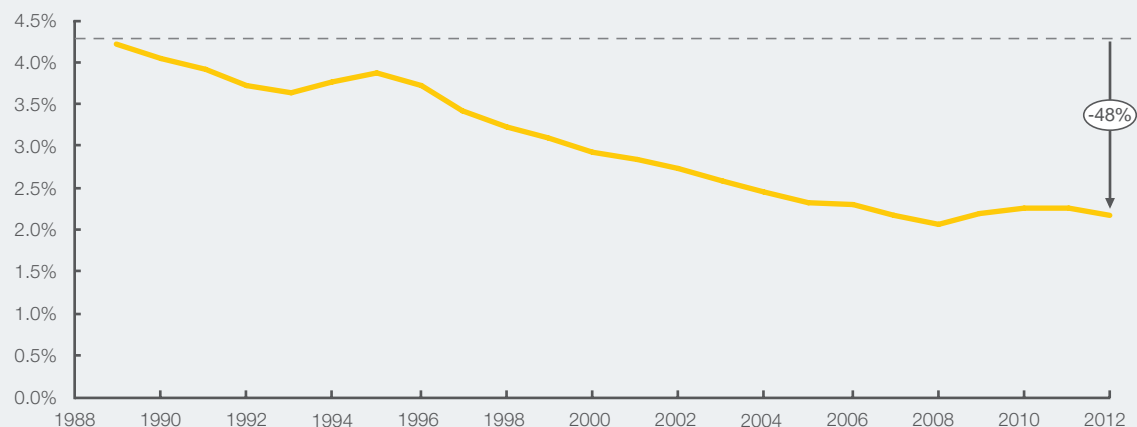


Source: RBA, Commonwealth Bank.

24 Measured by cost to asset ratio, a productivity indicator.

**Favourable pricing.** Net interest margins have declined (Figure 16, Figure 17) reflecting a reduced ability for banks to pass on funding costs. Consumers have also benefited from heightened competition for retail deposits through more favourable deposit rates than were on offer historically. Using a term deposit example, the average spread to the cash rate paid increased by over 200 basis points (bps) (two percentage points) between 2007 and 2013.

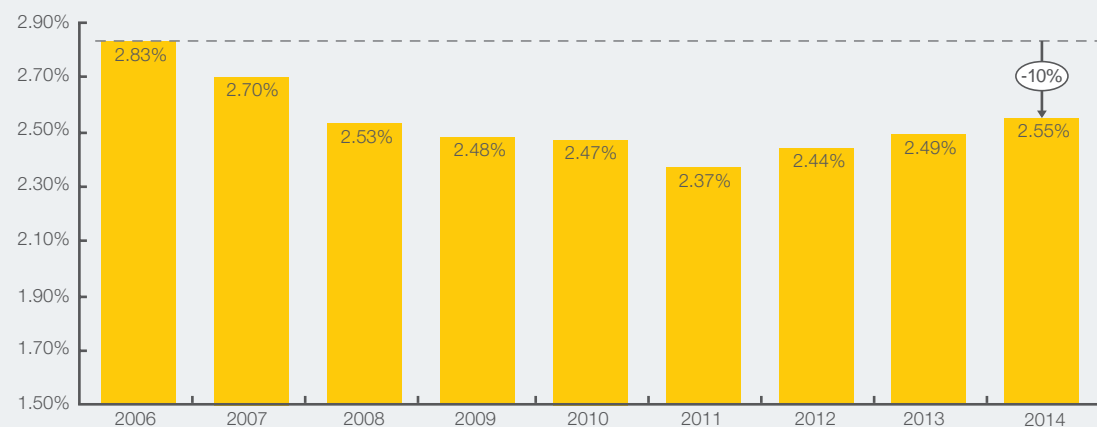
**Figure 16: Banks' net interest margin**



Source: Company filings.

Note: Based on simple average of the NIMs of the major four banks (Commonwealth Bank, Westpac, NAB, ANZ). The NIMs are calculated by banks' interest margin (difference between interest income and interest expense) divided by disclosed interest earnings assets. The NIMs for individual banks may be different from those reported by the individual banks but calculation of NIMs is consistent across all banks and through time.

**Figure 17: Commonwealth Bank Retail Banking Services net interest margin**



Source: Commonwealth Bank.

Note: Based on simple average of the NIMs of the major four banks (Commonwealth Bank, Westpac, NAB, ANZ). The NIMs are calculated by banks' interest margin (difference between interest income and interest expense) divided by disclosed interest earnings assets. The NIMs for individual banks may be different from those reported by the individual banks but calculation of NIMs is consistent across all banks and through time.



## CHAPTER 2: A FREE MARKET PHILOSOPHY FOR AUSTRALIA'S FINANCIAL SYSTEM

### SUMMARY

- A free market philosophy should underpin the design of the financial system. It maximises the efficient delivery of its functions through competition and business models that are sustainable through economic cycles.
- Regulation has a role to play in addressing potential failures. Its application should be balanced to ensure that it does not impede growth and efficiency in the economy.
- The following principles should apply to regulatory design:
  - The overall societal benefits should exceed the associated costs.
  - Regulators should be competitively neutral in terms of the types of organisations they regulate.
  - Regulations should not overlap.
  - Disclosures should allow comparison across domestic and international institutions.
  - Regulations should allow Australia to be recognised as 'equivalent' with international practice.
  - International standards should only be adopted where the problem which the standards are designed to address exists in Australia.
  - Regulations should only be in excess of international standards where the conditions in the domestic financial system warrant such particular treatment.

### 1. A FREE MARKET PHILOSOPHY UNDERPINS THE AUSTRALIAN FINANCIAL SYSTEM

Commonwealth Bank believes that a free market philosophy should underpin the design of the financial system in maximising the efficient delivery of its functions. The forces of supply and demand should, with reasonable checks, achieve the optimal outcomes for the economy and customers. Market forces encourage competition between existing and new market participants to achieve their respective objectives of maximising long-term, sustainable profitability.

The objective of long-term sustainable profitability also encourages financial institutions to adopt sustainable business models. Certain business models with, for example, weak capitalisation, liquidity and risk management discipline can thrive in supportive economic conditions, but prove to be less sustainable during downturns than properly-regulated ADIs. Only financial institutions with sound business and risk management behaviour can remain viable through the economic cycle in a free market environment.

### 2. THE PRINCIPLES OF REGULATION

A robust regulatory environment is critical to economic stability and protecting the financial wellbeing of the economy and customers through economic cycles. Australia's regulatory system played a major role in ensuring the resilience and sustained growth of the domestic economy during and following the GFC. **Adjusting the regulatory system to improve its effectiveness and efficiency will be important in ensuring that it is able to meet the challenges of Australia's future.**

Regulation addresses potential market failures to ensure that the following objectives are achieved for the financial system:

- Systemic stability and customer protection.
- Competition through low barriers to entry, a 'level playing field' and ability to achieve economies of scale.
- Transparency in market information and risk.
- Uniform access to market information across participants.
- Integrity and standards of conduct.

The financial system must remain resilient to inevitable downturns because the consequences of a failure can be severe. These consequences justify more conservative regulatory settings in the financial system than are applied to other sectors. Examples include bank capital, liquidity and customer identification requirements. While these settings may create minor inefficiencies during periods of economic growth, they are necessary to ensure that the system continues to function at the weakest point in the economic cycle.

**Commonwealth Bank supports principles for regulatory design and intervention that balance the trade-offs between preventing market failures and supporting the growth of the economy.** While there has typically been constructive intent behind regulatory design since the Wallis Inquiry, the development and implementation have not always adequately balanced this trade-off. The following principles should apply to regulatory design:

- **The overall societal benefits should exceed the associated costs.** New regulation typically adds complexity and increases compliance obligations and costs for system participants. These costs must be outweighed by the benefits realised through the achievement of one or more of the objectives discussed above.
- **Regulators should be competitively neutral in terms of the types of organisations they regulate.** Regulators should be informed by the risk an institution or activity represents and apply regulations uniformly. This will encourage competition and systemic stability as all providers of financial services are held to the same high standard. For example, some emerging technology-based providers currently enjoy lighter regulatory oversight than ADIs. This increases risk to the system as discussed in Chapter 8.
- **Regulations should not overlap.** Governing each activity with a single regulation increases certainty and simplicity for customers and providers and promotes cost efficiency. An example of where this has not occurred is the overlapping superannuation regulations governed by APRA and ASIC described in Chapter 10.
- **The design of financial institution disclosures should allow comparison across domestic and international institutions.** To promote fair competition domestically and competitive access to offshore markets, disclosure requirements should not place any Australian institution at a comparative disadvantage. An example of where this has not been achieved is the reporting of Australian bank capital ratios discussed in Chapter 5.

- **Regulations should take into account international standards to allow Australia's regulatory regimes to be recognised as 'equivalent' with international practice.**

Australia's regulations should be regularly benchmarked against international standards to ensure that where 'equivalence' is a desired state, this is maintained. The growing connectivity of financial systems is causing regulation to be shaped increasingly by global standards and in global forums. Encouragingly, there is an expressed intent to improve efficiency by enabling jurisdictions to defer to each other and respect home country regulatory regimes on the basis that sensible 'equivalence' is sought.<sup>25</sup>

- **International standards should only be adopted where the problem which the standards are designed to address exists in Australia.** If no similar issue is present then adoption would only add unnecessary cost to the system. Unchecked equivalence can open Australia up to possible future spates of international standards driven from one or more jurisdictions. For example, widespread product mis-selling in other jurisdictions has raised the possibility of new international standards being implemented in response. Such standards should only be adopted in Australia to the extent a similar mis-selling risk is prevalent domestically. Constructive approaches have been taken to ensure that international standards are appropriately applied in an Australian context. An example is the application of the Basel III Liquidity Risk Management rules discussed in Chapter 12.
- **Regulations should only be in excess of international standards, or 'super-equivalent', where the conditions in the domestic financial system vary from the norm and so warrant such special treatment.** Where there is a justified departure from international standards, disclosure regimes should be carefully designed to aid international comparability. Super-equivalence can unnecessarily place Australian financial institutions at a disadvantage to international peers through, for example, the appearance of being relatively undercapitalised. ASIC has worked through international bodies such as the International Organization of Securities Commissions (IOSCO) to ensure the international Over-The-Counter (OTC) Derivatives regime is appropriately applied to the Australian market.

---

25 G-20 Communique, Meeting of Finance Ministers and Central Bank Governors, Sydney, February 2014.

## CHAPTER 3: POSITIONING AUSTRALIA FOR A PROSPEROUS FUTURE

### SUMMARY

- Australia's future will be shaped by four major trends: technology developments, an ageing population, growth in the superannuation system, and greater exposure to global forces.
- Australia's strong economic fundamentals and proximity to growth markets will make it increasingly attractive. Its openness to offshore investment and migration and favourable environment (physical and social) will continue to make it attractive to investors, migrants and tourists.
- The financial system should evolve to address the challenges that have arisen since the Wallis Inquiry and those that will be presented by Australia's future.
- To continue to enhance the financial wellbeing of households, businesses and the community through future economic cycles, the financial system must:
  - Secure the future for Australian households.
  - Fund economic growth.
  - Innovate.
  - Maintain customer trust.
  - Remain resilient through economic downturns.
  - Provide security in retirement.
- Given the resilience and adaptability of the Australian financial system over the past two decades, we consider that significant changes to the financial system are not necessary.
- **The Inquiry should support the following objectives for the financial system:**
  - **Support a strong banking system:** Enhance the banking system's ability to facilitate long-term cost-effective funding to the economy.
  - **Protect Australians in the digital economy:** Enhance customers' confidence in the system's security by supervising system participants appropriately and updating privacy and cyber security frameworks.
  - **Ensure the superannuation system can fund Australia's retirement:** Build a world-leading superannuation system that is more efficient and appropriately regulated.
  - **Encourage regulatory efficiency and neutrality:** Strike the appropriate balance between applying uniform prudential and conduct oversight and enabling the growth ambitions of economy participants.

## 1. CONTEXT

The Inquiry will examine how the financial system can support the long-term growth and stability of the economy. The Australian economy has undergone significant changes since the Wallis Inquiry, as described in Chapter 1. The design of the financial system needs to respond not just to the challenges it faces as a result of historical change, but also to the challenges that future development of the economy will bring.

Commonwealth Bank expects that the economy's future will be shaped by four key trends. These will have specific implications for the financial system, which the Inquiry should address:

- Technology developments.
- Ageing of the population.
- Growth in superannuation.
- Connectivity with Asia and beyond.

## 2. TRENDS SHAPING AUSTRALIA'S FUTURE

### 2.1 Technology developments

Consumers have demonstrated a growing propensity to interact, consume and transact while on the move. Technology adoption is especially widespread among younger generations. This trend is being driven by and is driving advances in mobile hardware, software and bandwidth. Smartphones now account for 17% of total time spent on the internet, compared to 12% in 2011,<sup>26</sup> while mobile internet users will overtake desktop internet users in 2014 (at a global level).<sup>27</sup> This trend will continue to accelerate and evolve.

In financial services, advances in mobile technology will encourage changes in service and security. Financial services via mobile devices open up opportunities for faster delivery, greater convenience, new services, and wide-reaching financial literacy support, while bringing significant productivity benefits to the overall economy. Delivery of financial services using technology allows customers to interact with financial institutions at a time and through a channel of their choosing. The size and design of branches will be reshaped to reflect shifting customer preferences. Further, the industry is investing in real-time banking for payments and transactions. Research suggests that investment in technology is an important source of innovation and economies of scale in banking. Given the large costs often associated with technology projects, large and profitable banks are typically best able to make the necessary investment.<sup>28</sup> Commonwealth Bank's Core Banking Modernisation investment is an example of this investment.

**Rapid innovation into a highly regulated sector creates an incentive for entrants to employ new business models, some of which may avoid regulation. This will increasingly complicate the definition of what constitutes a financial services institution and will create risks which could become systemic weaknesses and compromise customer security. Investment is required in cyber-security to mitigate the risk from sophisticated digital criminals.**

26 GfK, MultiMedia Mentor® research. Survey results based on interviews with 2,616 members of KnowledgePanel® in the U.S. Interview was conducted between February and July 2012 with panel members ages 13 to 64.

27 Morgan Stanley.

28 Hughes, J. and L. Mester, 'Who said banks don't experience scale economies? Evidence from a risk-return driven cost function', *Journal of Financial Intermediation*, 2013, pp. 22-4.



## 2.2 Ageing of the population

Across the developed world, including Australia, the average age of the population is rising. This trend is driven by a combination of longer life expectancy and declining fertility. By 2040, 25% of the population will be over 65.<sup>29</sup>

The ageing population will change the financial services industry's mix of funding sources and its profitability while shifting product demand. As a population ages, individual asset allocation typically shifts from growth assets, such as equities and real estate, to lower risk assets, such as fixed income and deposits. This will increase the proportion of bank liabilities comprised of deposits versus wholesale funding. Additionally, demand for fixed income products, especially retirement income streams, will increase both directly from individuals as well as from superannuation funds, as the population shifts from accumulation to draw down. As a result, a deeper domestic fixed income market is likely to develop. Finally, a higher proportion of the population in post-retirement years will constrain domestic economic growth.

## 2.3 Growth in superannuation

Superannuation fund assets are experiencing rapid growth. Rice Warner projects asset levels increasing from \$0.2 trillion in 1994 to \$6 trillion 2030.<sup>30</sup> By 2030, superannuation assets will grow to approximately 160% of GDP, above the OECD weighted average (77%)<sup>31</sup> and of similar scale to the banking system.

The superannuation system's growth will shift the demand for certain asset classes, and will drive improvements in the way superannuants' funds are serviced upon payout. Superannuation funds require investment opportunities that match their investment horizon and risk appetite. Long-dated asset classes (e.g. infrastructure) and asset classes that provide diversification (e.g. fixed income) will need to grow to meet this increased demand. Additionally, the greater number of retirees will stimulate demand for income stream products to manage their longevity.

## 2.4 Connectivity with Asia and beyond

The world is increasingly global and characterised by cross-border economic, political and cultural exchange. Consequently, consumers and businesses are increasingly demanding access to global financial services that facilitate the flow of goods and people. The development in technology also advances connectivity and mobility of information across regions.

The scale and pace of development in Asia and Africa is unprecedented. Asia is now a significant component of the global economy and Africa is in the early stages of a similar growth trajectory to Asia. Changes in Asia are being driven by decades of rapid economic growth in the world's most populous countries (India, China and Indonesia) and are creating a rapidly emerging middle class. This will ultimately create three billion new regional financial services customers who had previously never used a bank.

These greater links between countries and a burgeoning Asian middle class present both opportunities and risks for the financial system. Super-regional banks, pan-Asian regional processing and clearing platforms, and new innovative business entrants are likely to emerge. They will seek to capitalise on the growing flow of goods, capital, and people along the Australia-Asia corridor as well as throughout the wider Asia region. Financial services firms and regulators will need to work together, both to facilitate the growth of these multinational entities as well as to prepare for risks arising from economic and financial interconnectedness, such as financial contagion, asset bubbles, and currency wars.

---

29 ABS, 'Population Projections', November 2013.

30 Rice Warner, 'Superannuation Market Projections', 2012.

31 OECD, 'Pension Markets in Focus', 2013.

### 3. A POSITIVE OUTLOOK FOR THE AUSTRALIAN ECONOMY

The outlook for Australia is positive. Proximity to growing markets, a stable economy, responsible government and an open culture contribute to Australia's increasing attractiveness as a destination for capital and immigration.

The country's economic stability and resilience will continue to attract strong flows of foreign direct investment (over US\$300 billion from 2013 to 2017)<sup>32</sup> and immigrants (net immigration of 1.25 million from 2013 to 2017).<sup>33</sup>

As the population and amount of capital invested grows, demand for housing and infrastructure such as roads, ports and water facilities will increase beyond current supply. This will have implications for financial institutions which act as intermediaries in the capital flows required to support growth while maintaining systemic stability.

### 4. THE FINANCIAL SYSTEM'S ROLE IN AUSTRALIA'S FUTURE

The economy has performed well and the financial system has been a key pillar of support. Customers have been well-served, competition is vibrant, the system has been stable and Australians have become increasingly well-prepared for a self-funded retirement. As such, we do not consider that fundamental change to the financial system is needed. However, Australia's future will present challenges and the financial system must evolve to address them.

**Commonwealth Bank believes that the two highest priorities for the evolution of the financial system are customer wellbeing and system resilience.**

The design of the system must have customers' convenience, financial and security interests at its heart. The financial system must engage customers in their financial affairs and provide them with the services and capital to deliver a sustainable quality of life and to meet their growth ambitions.

In supporting customers, the financial system's intermediaries and supervisors must cooperate to prevent failures that could compromise trust and the security of capital flows. Australia has been a global leader but must continually adapt its standards to respond to emerging threats.

The Inquiry should support the following primary objectives to continue to enhance the financial wellbeing of households, businesses and communities through future economic cycles:

- **Securing the future for Australian households:** Provide access to financing for the housing, personal finance and infrastructure needs of a growing population.
- **Funding economic growth:** Ensure reliable access to cost-effective capital flows to finance small and large businesses, both onshore and offshore, and the infrastructure needs of the country.
- **Innovation:** Increase innovation to maintain Australia's technology leadership and adapt to the more mobile and sophisticated needs of individuals and businesses.
- **Security in retirement:** Enable secure, self-funded retirement income streams that appropriately match life stage needs.
- **Trust:** Protect customers' security to give them the confidence to participate in the economy and utilise the benefits of innovation.
- **Resilience:** Maintain the strength of the system to protect the economy through economic cycles.

32 IMF, 'International Financial Statistics'.

33 ABS, 'The Outlook for Net Overseas Migration', September 2013.

To equip the financial system to achieve these objectives, Commonwealth Bank **recommends** that the Inquiry focus on:

- **Supporting a strong banking system** (Section II): Enhance the banking system's ability to facilitate long-term cost-effective funding to the economy by improving the depth and robustness of the domestic fixed income market and using internationally equivalent base capital ratios. Address implicit guarantees with suitable orderly resolution tools for crisis management. A healthy banking system is critical to a well-functioning financial system.
- **Protecting Australians in the digital economy** (Section III): Enhance customers' confidence in the system's security by regulating system participants appropriately and updating privacy and cyber security frameworks.
- **Ensuring the superannuation system can fund Australia's retirement** (Section IV): Build a world-leading superannuation system that is more efficient and appropriately regulated. Establish incentives for adequate savings and innovation in retirement products designed to reduce the likelihood of calls on the tax system.
- **Encouraging regulatory efficiency and neutrality** (Section V): Strike the appropriate balance between uniform prudential and conduct oversight while enabling the growth ambitions of economic participants. Take a through the economic cycle view in the development of regulation.

Specific customer challenges that the Inquiry could assist in addressing are households' financial literacy and access to an efficient insurance system; small businesses' access to finance; and governments' desire to support development of the infrastructure needs of a growing economy. These are discussed in Section VI.

cash & cheque in

**COMMONWEALTH  
BANK SUPPORTS  
PRINCIPLES FOR  
REGULATORY  
DESIGN AND  
INTERVENTION  
THAT BALANCE  
THE TRADE-  
OFFS BETWEEN  
PREVENTING  
MARKET FAILURES  
AND SUPPORTING  
THE GROWTH OF  
THE ECONOMY.  
COMMBANK CAN.**





## SECTION II: SUPPORTING A STRONG BANKING SYSTEM

A sound and well-functioning banking system is a critical component of any financial system, as the experience of many developed markets would illustrate since the GFC. The Australian banking system has proven resilient in its ability to provide constant availability of credit to the economy while this ability has been severely constrained in other markets over recent years.

The Australian economy is notably reliant upon bank-intermediated credit, and as such, growth of the banking sector has accompanied growth in the broader economy. In addition to their role in financing the economy, banks are important in supporting activity in other service sectors and in being a significant direct and indirect investment choice for Australian households.

**Commonwealth Bank supports a banking system that is shaped by market forces and therefore should comprise a range of financial institutions – large and small, national and regional, corporate and member-based.** It is important to strike a balance between banking system strength and allowing the Australian banks to generate sufficient capital from earnings to support the growth of the economy.

Large banks facilitate confidence in the banking system as a whole while encouraging innovation and competition. They are able to assist in addressing risks which may build up in the broader financial system, for example in the shadow banking sector or when smaller banks require support.

Recent Australian banking history as described in Chapter 1 demonstrates that, while large banks may experience difficulty from time to time, smaller banks are more likely to experience distress and require support from the large banks (State Bank of South Australia, State Bank of Victoria, and Bankwest). The impact of a small bank failure, or even an offshore bank failure that affects confidence in the global banking sector (such as Northern Rock and Lehman Brothers), can be highly destabilising.

Commonwealth Bank believes that a strong banking system is supported by:

- Sustainability of funding options for Australian banks.
- Comparability of Australian bank capital ratios to international peers.
- A supportive operating framework for the whole banking system.
- An appropriate framework for managing risk from the shadow banking sector.

These initiatives provide benefits to the entire banking sector.

## CHAPTER 4: ENSURE SUSTAINABLE FUNDING FOR AUSTRALIAN BANKS

### SUMMARY

- Historically, credit growth in Australia has exceeded deposit growth. To meet this funding gap, the Australian banks have relied on the debt markets, both domestic and offshore.
- The domestic debt markets, both retail and wholesale, are relatively under-developed compared to those in other comparable jurisdictions.
- Consequently, the Australian banks are reliant on, and compete in, offshore debt markets. As evidenced during the GFC, this reliance can affect the Australian banks because offshore debt markets may be influenced by offshore factors and may not have regard to positive Australian factors.
- During crisis periods, investors require higher margins on debt, while some may reduce their investments or cease investing altogether. The resulting higher cost of funds is passed on to both retail and institutional customers and the Australian banks may have to rationalise their balance sheets, choosing to reduce lending or to cease lending altogether.

### RECOMMENDATIONS

- 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 Australian bank issuances 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.
- Enable Australian banks to issue a range of security types to suit market conditions, including an increase in the permitted level of covered bonds and residential mortgage-backed securities (RMBS) through master trusts.

### 1. CONTEXT

The ability to obtain funding is critical to the Australian banks' ability to make credit available to the economy, and is therefore critical to the overall growth of the economy.

Historically, credit growth in Australia has exceeded deposit growth. To meet this funding gap, the Australian banks have relied on the debt markets, both domestic and offshore. In addition, the Basel III rules for liquidity and funding require banks to improve the stability of funding by placing higher value on stable household deposits and long-term debt, and lower value on wholesale client deposits and short-term debt.

The domestic debt markets, both retail and wholesale, are relatively under-developed compared to those in other comparable jurisdictions. Consequently, the Australian banks are reliant on, and compete in, offshore debt markets. As evidenced during the GFC, this reliance can severely affect the Australian banks because offshore debt markets may be influenced by offshore factors and may not have regard to positive Australian factors. Furthermore, to the extent Australian investment fundamentals deteriorate, the Australian banks' ability to refinance existing offshore debt as well as fund new credit demand will be impacted.

During crisis periods, investors require higher margins on debt (Figure 18), while some may reduce their investments or cease investing altogether. The resulting higher cost of funds is passed on to a significant degree to both retail and institutional customers and the Australian banks may have to rationalise their balance sheets, choosing to reduce lending or to cease lending altogether. This would occur at the same time as policymakers (both the Government and RBA) would likely be seeking support from the Australian banks to assist growth in the economy.

**Figure 18: Commonwealth Bank CDS pricing during and since the GFC (US\$ 5 year)<sup>34</sup>**



Source : Bloomberg.

Even in current favourable market conditions, the Australian banks encounter investors with limited investment appetite because of macroeconomic concerns such as the exposure of the Australian economy to China and exposure of the Australian banks to the residential property market.

Consequently, Commonwealth Bank supports sustainable funding options for the Australian banks. This involves:

- Improving the depth and liquidity of the domestic debt markets.
- Enabling Australian banks to issue a range of security types to suit market conditions.

Strong domestic debt markets would significantly reduce risks to the Australian banking sector by reducing reliance on offshore debt markets, thereby reducing contagion risk from offshore events and the need to hold additional capital for such risk.

<sup>34</sup> CDS (credit default swap) are derivative transactions which enable hedging of the debt of the underlying entity. The cost of CDS is provided in bps and is a homogenous benchmark by which to compare issuer funding costs.

## 2. SUPPORTING SUPPLY TO THE DOMESTIC DEBT MARKETS

### 2.1 Context

It is important for issuers that debt markets be deep and liquid. This enables issuers to issue securities at competitive margins, achieve higher volumes and to issue a range of security types to suit market conditions.

Benchmarking of margins is improved by maintaining a large market with a range of issuers issuing a range of security types. The trend of margins demonstrated through a range of issuers with different credit-worthiness is often referred to as ‘the credit curve’.

The credit curve also assists the market to benchmark other important products such as annuities and longevity insurance.

Issuance of new securities (‘primary’ issuance) supports the development of secondary (i.e. after-market) trading and the market for repurchase agreement (‘repo’) trading, which further improve the liquidity of the market.

### 2.2 Development of the domestic corporate bond market

Issuance by corporates, other than banks, provides data points for the credit curve and attracts investors.

The Treasury recently proposed reforms for simple corporate bonds (bonds issued by corporates which are senior-ranking and whose other terms are vanilla). The reforms included streamlined prospectus disclosure requirements, removal of the requirement for a trustee to hold the bonds on behalf of investors, and removal of potential directors’ liability for material mis-statements and omissions in the prospectus. Potential corporate liability for material mis-statements and omissions would not change.

The draft legislation for the reforms lapsed before Parliament in 2013.<sup>35</sup> Commonwealth Bank **recommends** that the reforms be enacted as soon as possible and that the subsequent regulations relating to disclosure be carefully drafted to ensure that such disclosure will be streamlined.

It should be noted that the Australian banks do not directly benefit from these reforms.<sup>36</sup> However, Commonwealth Bank is supportive of the proposed changes, as they will assist the development of the domestic debt markets generally.

### 2.3 Development of the ABS market

ABS are securities where investors’ repayment is dependent upon an identified pool of assets. The process of identifying assets, and issuing different classes of securities based on these assets, is called securitisation. Securitisation techniques, including ABS and covered bonds, have been used in numerous offshore jurisdictions to build deep and liquid debt markets for homogenous assets such as mortgages, credit cards and auto-finance. Many jurisdictions, most notably the US, Canada and Scandinavia, have developed domestic markets that provide deep and efficient local currency funding for issuers, and transparent and liquid investments for investors.

The Australian banks are currently the largest issuers of ABS through the RMBS program. Under APRA’s standards, the Australian banks are encouraged only to issue RMBS for funding reasons.

---

<sup>35</sup> Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2013.

<sup>36</sup> Under section 708(19) of the Corporations Act, Australian banks can offer debentures, including senior bonds, to retail investors without the requirement to prepare a prospectus.



Although the securities are dependent upon the underlying pool of residential mortgages and the risk of those mortgages is effectively transferred to investors, the Australian banks' ability to obtain relief from holding regulatory capital for those assets is reduced by technical rules and caps.<sup>37</sup> If the Australian banks were allowed full capital relief, there would be more ABS issuance. Therefore, Commonwealth Bank **recommends** that there be a review of the need for the technical rules and caps.

In Australia, each tranche of RMBS must be issued through an individual corporate structure (this is referred to as a 'closed pool' RMBS). The Australian banks could more efficiently issue RMBS by issuing multiple tranches through a single 'master trust'.

The benefits of a master trust over the 'closed pool' structure are:

- Simplifies assessment of credit risks of an RMBS issuer as the single pool of assets applies to all issues.
- Facilitates the issue of more vanilla-style bonds (i.e. coupon and bullet repayment) rather than principal pass-through amortising bonds.
- Allows the establishment of larger benchmark RMBS lines, enhancing transparency and liquidity.
- Allows more cost-efficient issuance of RMBS securities denominated in foreign currencies (the costs of managing the foreign exchange conversion are lower using this structure).
- Widens the potential collateral range to include, for example, credit card receivables for which there are deep and efficiently-priced international funding markets.

APRA is currently reviewing the prudential standard for securitisation and Commonwealth Bank **recommends** that APRA revise the standard to allow the issuance of RMBS through master trusts.

## 2.4 Issuance by governments and semi-government entities

Issuance by governments is critical to contribute data points for the credit curve. It also attracts investors to the debt markets.

Commonwealth Bank supports the continued issuance of Commonwealth Government securities (CGS), including in budget surplus periods. During surplus periods, debt funding could be justified for infrastructure and other projects in the national interest. Commonwealth Bank **recommends** that the Australian Government supports the development of the credit curve by expanding CGS issuance to include 20 to 30 year bonds as well as longer-dated inflation-linked bonds.

Issuance by State governments also provides data points for the credit curve and attracts investors. The RBA has confirmed that the recent growth in the State Government bond market has contributed to the development of the broader debt markets.<sup>38</sup> The Australian Government can support State Government issuance through mechanisms such as the guarantee scheme for State and Territory borrowings introduced in 2009 (closed to new issuance in December 2010). This may be appropriate in the future for non-crisis related situations such as joint Australian and State Government infrastructure projects.

Similarly, issuance by quasi-government entities such as Australia Post, Airservices Australia and the Commonwealth Scientific and Industrial Research Organisation (CSIRO) would provide benchmarking opportunities for bank and corporate issuers.

<sup>37</sup> Technically, this occurs because issuers divide the risk of the assets into a first-loss piece (subordinated bond tranche) and the balance of the risk – they retain the subordinated bond tranche and sell the balance of the bonds to investors. If an Australian bank retains a subordinated bond tranche of RMBS, then it is not entitled to capital relief for the whole of the transaction. In addition, it is proposed that, even if an Australian bank was able to sell the subordinated bond tranche, capital relief would be capped at 80% (requiring the bank to continue to hold 20% of the capital). If an Australian bank structured a first-loss piece and a second-loss piece, capital relief would be capped at the lower percentage of whichever tranche it had sold. Source: Charles Littrell, APRA, 'Prudential Reform in Securitisation', 11 November 2013.

<sup>38</sup> David Lancaster and Sarah Dowling, RBA, 'The Australian Semi-Government Bond Market', RBA Bulletin, September 2011.

## 2.5 Market liquidity assistance from the RBA

To support development of domestic credit markets, Commonwealth Bank **recommends** that the RBA should consider developing further liquidity facilities that would support market depth and liquidity as well as being instruments for monetary policy. These have been implemented in other jurisdictions to support overall market liquidity.

Introducing a wider range of regular repo actions which are set at market clearing levels, without any negative perception from participation, will provide support to market broadening activity.

Such liquidity could be withdrawn from the system by the RBA accepting surplus funding at the cash rate rather than at a penalty of 25 bps below the cash rate. By removing the negative cash spread on deposits with the RBA, banks would be more willing participants in both providing and receiving financing.

## 3. SUPPORTING DEMAND IN THE DOMESTIC DEBT MARKETS

### 3.1 Context

A broad investor base is required to support deep and liquid debt markets.

The Australian banks issued approximately \$119 billion of wholesale long-term debt in 2013 of which only \$45 billion (38%) was issued in the domestic debt markets. This included \$24 billion of senior debt and \$17 billion of RMBS. Total debt issuance in the domestic debt markets was approximately \$140 billion, of which Australian banks accounted for only 32% of the total.

Australian investors prefer to invest in equities because of a range of factors including high dividend yields and attractive long-term capital returns.

This preference is evident in the allocation of superannuation assets. In 1988, 30% of household financial assets were held in superannuation compared to 47% today.<sup>39</sup> The current allocation of superannuation is 50% to equities, 25% to fixed income, and 25% to property and other asset classes.<sup>40</sup>

With the superannuation sector currently managing \$1.6 trillion<sup>41</sup> of funds and projected to manage \$6 trillion by 2030,<sup>42</sup> it is critical to engage this sector in the development of the domestic debt markets.

While Commonwealth Bank does not recommend compulsory investment allocations for either retail, institutional or superannuation investors, Commonwealth Bank believes it is important to provide a balanced opportunity for investors. This involves the following:

- Ensuring the tax system provides the appropriate balance of incentives to invest in all asset classes.
- Ensuring investors understand the risk-return trade-off. If retail investors better understand the trade-off, this will assist with attracting superannuation sector funds.

39 ABS, 'Australian National Financial Accounts', Car 5232.

40 Mercer, 'Asset Allocation of Pension Funds Around the World', February 2014.

41 APRA, 'APRA releases quarterly superannuation statistics for September 2013', Media Release, 21 November 2013.

42 Rice Warner, 'Superannuation Market Projections', 2012.

### 3.2 Tax system features to encourage debt investment

The Australian tax system has a number of features which encourage investors to invest in equities and property rather than debt:

- Negative gearing allows investors to borrow to invest and to claim a tax deduction for interest costs. Investors have an incentive to do this via equities and property, which are more likely to be inflation-driven and increase in value as opposed to fixed income investments. The dividend or rental income may not cover the borrowing cost but the cost is subsidised by the tax saving and the balance of the borrowing cost is made up over time through capital appreciation (some of this capital appreciation is effectively compensation for inflation).
- Capital gains tax defers the time at which profit on investments, particularly equities and property which again are more likely to be inflation-driven and increase in value, is paid.
- The discount on capital gains on investments held for more than 12 months significantly reduces the tax paid on these profits.

The combination of all three mechanisms of negative gearing, tax deferral and the capital gains tax discount influences investment away from debt.

These features have a significant impact upon investor demand in the domestic debt markets, which then discourages issuers from using the market.

It is beyond the scope of this submission to make recommendations about the retention of these distinctive features of the tax system. However, if these features are retained, Commonwealth Bank **recommends** that measures be implemented to encourage investors to invest in debt. Specifically, Commonwealth Bank believes it is necessary to CPI-adjust long-dated income earnings from fixed income, where debt investment is most disadvantaged from a tax perspective.

In 2010, Australia's Future Tax System Review recommended introducing a tax discount of 40% for interest income, net residential rental property income, and capital gains, with the specific aim of ensuring a more consistent outcome across these asset classes. Commonwealth Bank suggests that this discount be introduced for long-term fixed income securities. By limiting the measure to long-term instruments, the impact upon the Government revenue would be minimised.

Such a measure would be attractive to both individuals and superannuation funds. The ability to issue such securities would also facilitate the provision of debt funding for Australian infrastructure projects.

### 3.3 Investor education about the risk-return trade-off between fixed income and other asset classes

As previously mentioned, there is an Australian investor preference for equities.

Commonwealth Bank believes that this preference may change if retail investors understood that higher yields are a return for taking higher risk. Retail investors should have a firmer grasp of the risks of investing in equity, including the discretionary nature of dividends and that both dividends and capital appreciation are subject to the risks of the underlying business.

Investors should understand the risks of investing in debt but also the relative benefits. Issuers attempt to assist by explaining the differences between equity and debt in prospectuses and this type of disclosure has significantly improved over recent years. However, these are limited opportunities and only the Government is in a position to take on a broader responsibility.

**Commonwealth Bank believes that broad financial literacy of retail investors is critical and recommends that there be a concerted focus on financial literacy.** This will also assist with investors' understanding of the importance of investing appropriately for their life stage. The issues of financial literacy and life stage investing are discussed in more detail in Chapter 13.

Such investor education should include education about products such as annuities (relevant to life stage investing), which will further assist to promote interest in fixed income.

### 3.4 Development of the ABS market

On the investment side, for the Australian banks, ABS is a low risk investment with secondary market liquidity characteristics. In part, this is because certain ABS issued by other banks are repo-eligible with the RBA. However, the Australian banks are discouraged from investing in ABS for the following reasons:

- Australian banks are generally required to hold regulatory capital for ABS investments based on risk-weightings determined by external ratings.<sup>43</sup> Although the Australian banks may have a more positive internal view of the credit-worthiness of the investments, they cannot use their Advanced models<sup>44</sup> to determine this. This applies to investing in both corporate and bank ABS. The Basel Committee is currently reviewing this area and may suggest further changes which similarly do not assist the ABS market.<sup>45</sup>
- Australian banks are required to hold regulatory capital at higher risk-weightings for subordinated bond tranches issued by other banks.<sup>46</sup>
- Under the Basel III liquidity reforms as implemented in Australia, external RMBS (i.e. issued by another financial institution) is not eligible as high quality liquid assets (HQLA) and investments need to be considered having regard to the Australian banks' finite capacity under the Committed Liquidity Facility.<sup>47</sup> In other jurisdictions, external RMBS is HQLA-eligible. If it were HQLA-eligible in Australia, the Australian banks would have an incentive to invest more in this asset class as part of their overall liquidity portfolio mix. The potential capacity within the major banks' liquidity portfolios for additional HQLA is substantial given APRA's estimate that there will be a market-wide Australian dollar Level 1 HQLA shortfall of \$282 billion.<sup>48</sup> Therefore, as investors, the major banks are a potentially significant source of liquidity for the non-major banks.

Commonwealth Bank **recommends** that there be a review of the existing and proposed rules, with a view to improving the capital and liquidity treatment of these securities for investors.

## 4. ENABLING AUSTRALIAN BANKS TO ISSUE A RANGE OF SECURITY TYPES AS A POTENTIAL SOLUTION

### 4.1 Covered bonds

Covered bonds are debt securities issued by a bank where the bank is primarily liable for repayment but, in the event of non-payment, investors have dual recourse to the bank and a segregated pool of home loans or other assets which secure the covered bonds. International peers, notably in Europe,

43 APS 120, Attachment D, paragraph 2.

44 As part of the introduction of Basel II, a number of the Australian banks received approval from APRA to calculate credit risk weighted assets through a model (called an Advanced model) which uses internal estimates of probability of default, loss given default and exposure at default.

45 Basel Committee on Banking Supervision, 'Consultative Document: Revisions to the Basel Securitisation Framework', December 2012.

46 APS 120, Attachment D, paragraph 6.

47 The Committed Liquidity Facility is a facility provided by the RBA which enables participating banks to access a pre-specified amount of liquidity by entering into repurchase agreements of eligible securities outside the RBA's normal market operations. The banks will be required to pay ongoing fees to access the facility. The facility supports the liquidity reforms introduced in Australia as part of Basel III.

48 APRA, 'Letter from APRA to all ADIs subject to the Liquidity Coverage Ratio', 30 January 2014.

have issued covered bonds for several decades and the covered bond market was one of the most resilient during the GFC.

In 2012, relevant APRA standards and amendments to the Banking Act were passed which allow Australian banks to issue covered bonds. Commonwealth Bank commends this initiative which has allowed the Australian banks to access a wider range of investors at an efficient cost.

Since the introduction of these amendments, Australian banks have issued nearly \$15 billion worth of covered bonds in the domestic market and a further \$56 billion worth offshore.

Australian banks are able to issue covered bonds up to a limit where the value of assets securing the covered bonds does not exceed 8% of the relevant bank's Australian assets. Commonwealth Bank **recommends** that the 8% limit should be increased,<sup>49</sup> particularly if the Australian banks are to issue covered bonds to contribute to the development of domestic debt markets (see Section 2 above). A number of peer jurisdictions have limits greater than 8% or no limit at all (Figure 19).

**Figure 19: Covered bond limits – Australia and peer jurisdictions**

Country	Covered Bond Limit
Australia	The nominal amount of covered pool assets securing covered bond issuance cannot exceed 8% of the deposit taking institution's assets in Australia
Canada	The nominal amount of covered bonds outstanding cannot exceed 4% of the deposit taking institution's total assets. However, the Canadian Government also operates a scheme under which residential mortgages can qualify for a Government guarantee.
Denmark	No limit
Netherlands	No limit
Finland	No limit
France	No limit
Germany	No limit
New Zealand	The nominal amount of covered bonds outstanding cannot exceed 10% of the deposit taking institution's total assets
Norway	No limit
Singapore	The nominal amount of covered bonds outstanding cannot exceed 4% of the bank's total assets
Sweden	No limit
UK	No limit

Source: Commonwealth Bank.

Further, a limit could be considered for all encumbrances (i.e. the claim or charge of a lender over the pool of assets), rather than selectively for covered bonds. This would ensure a holistic review of asset usage for financing and would protect depositors and other unsecured creditors against over-utilisation for funding.

## 4.2 RMBS and master trusts

This issue is discussed in Section 2.3.

<sup>49</sup> The covered bond limit may be raised through regulations made pursuant to section 28 of the Banking Act.

## CHAPTER 5: ENABLE COMPARABILITY OF AUSTRALIAN BANK CAPITAL RATIOS TO INTERNATIONAL PEERS

### SUMMARY

- As a result of local regulatory adjustments applied by APRA, when the Australian banks approach the capital markets for equity and debt, they are perceived as having capital ratios which are up to 4.2 percentage points lower than international peers. This significantly understates the Australian banks' strong capital levels and leads to a perception that they are less well capitalised (and therefore riskier).
- Investors require less capitalised banks, or banks which are perceived to be less capitalised, to pay higher yields on equity and higher margins on debt.
- During a crisis period, investors may, on the basis of perceived lower capital levels, rapidly reduce or exit their investments in the Australian banks or cease investing altogether. This may require the Australian banks to rationalise their balance sheets, choosing to reduce lending or to cease lending altogether.
- Commonwealth Bank understands the need for banks to hold higher levels of capital after the GFC and supports the current levels held by the Australian banks. Commonwealth Bank's concern is about comparability of capital ratios against international peers rather than concerns about actual levels of capital.

### RECOMMENDATION

- Local regulatory adjustments should be included in the Australian banks' Pillar 2 adjustment. This would allow the Australian banks to publish Pillar 1 capital ratios which are comparable with international peers.

### 1. CONTEXT

APRA requires the Australian banks to maintain certain levels of capital to manage risks. APRA has adopted capital standards which are more conservative than the international standards set by the Basel Committee on Banking Supervision (Basel Committee) and in almost all key banking jurisdictions. This has recently been confirmed by the IMF<sup>50</sup> and by the Basel Committee itself.<sup>51</sup>

This conservatism has a real cost to the Australian economy because it affects the ability of the Australian banks to efficiently raise equity and debt. The resulting higher cost of funds is passed on to both retail and institutional customers, for example through higher mortgage rates and higher lending margins. As a further example, in segments such as large institutional lending, the Australian banks bear significantly higher costs compared to international peers which are subject to less onerous capital requirements.

Furthermore, the availability of credit to the economy is constrained, particularly in periods where bank ability to generate capital is limited. In addition, the higher level of equity required reduces returns to shareholders.

50 IMF, 'Australia: 2013 Article IV Consultation – Staff Report', Country Report No. 14/51, February 2014.

51 Basel Committee on Banking Supervision, 'Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III regulations – Australia', March 2014.

When the Australian banks approach the capital markets for equity and debt, they are perceived as having capital ratios which are up to 4.2 percentage points lower than international peers. This significantly understates the Australian banks' strong capital ratios and leads to a perception that they are less well-capitalised (and therefore riskier). At 31 December 2013, Commonwealth Bank reported a Common Equity Tier 1 capital ratio under APRA's standards of 8.5%. If Commonwealth Bank were regulated in Canada, this ratio would be reported as 12.7%.

While the Australian banks commit considerable time to explaining their capital ratios to investors and analysts, such technical explanations require reiteration or are met with skepticism because internationally harmonised ratios are not recognised by bank regulators and bank regulators are not transparent about their regulatory approaches.

Less well capitalised banks, or banks which are perceived to be less well capitalised, are required to pay higher yields on equity and higher margins on debt. For example, Commonwealth Bank believes this is one factor which causes our credit default swap (CDS)<sup>52</sup> pricing to be higher than some of our lower-rated peers, putting us at a competitive disadvantage (Figure 20).

**Figure 20: CDS pricing – Commonwealth Bank and peer banks**

Bank	Credit rating	CDS pricing (bps)	Difference from Commonwealth Bank CDS pricing (bps)
'AA-' banks			
Commonwealth Bank	Aa3 / AA-	78	N/A
HSBC Bank	Aa3 / AA-	72	(6)
Toronto Dominion	Aa1 / AA-	53	(25)
Royal Bank of Canada	Aa3 / AA-	45	(33)
'A+' banks (1 notch lower than Commonwealth Bank)			
Wells Fargo	A2 / A+	42	(36)
'A' banks (2 notches lower than Commonwealth Bank)			
Deutsche Bank	A2 / A	84	6
'A-' banks (3 notches lower than Commonwealth Bank)			
Bank of America	Baa2 / A-	67	(11)
Barclays	A3 / A-	94	16
Citigroup	Baa2 / A-	79	1
Credit Suisse	A2 / A-	71	(7)
Lloyds Bank Group	A3 / A-	78	-
'BBB+' banks (4 notches lower than Commonwealth Bank)			
Royal Bank of Scotland	Baa1 / BBB+	113	35

Source: Bloomberg as at 15 March 2014.

<sup>52</sup> CDS are derivative transactions which enables hedging of the debt of the underlying entity. The cost of CDS is provided in bps and is a homogenous benchmark by which to compare issuer funding costs.

During a crisis period, investors may, on the basis of perceived lower capital levels, rapidly reduce or exit their investments in the Australian banks or cease investing altogether. Notably, such an event could reduce the Australian banks' access to offshore debt markets, which the Australian banks are reliant on, and compete in, for funding. This may require the Australian banks to rationalise their balance sheets, choosing to reduce lending or to cease lending altogether.

In addition, under the Basel III reforms, various triggers have been set based on capital levels which, if triggered, would have significant implications for both equity and debt investors (e.g. ability to pay dividends and hybrid distributions, conversion of hybrid capital securities into equity). For Australian banks, these triggers are based on APRA capital ratios and, because these are substantially lower than internationally harmonised capital ratios, Australian banks need to hold even higher levels of capital to avoid potential breaches. This results in a higher overall cost of funds.

## 2. CONSERVATISM IN AUSTRALIAN BANK CAPITAL RATIOS

The main areas of conservatism applied to the Australian banks by APRA are in relation to:

- The treatment of equity investments.
- The treatment of deferred tax assets.
- The requirement to hold capital for interest rate risk in the banking book.
- The application of a high downturn loss given default floor for mortgage portfolios.

Further information about these areas is available in Appendix I. In March 2014, the Basel Committee itself identified 27 areas where APRA's standards are stricter than the Basel Committee's minimum standards.<sup>53</sup>

Australian banks commit considerable time to explaining their capital ratios to analysts and investors. The Australian Bankers' Association has twice published a fact sheet explaining the differences between APRA's application of the capital standards and that of the UK and the Basel Committee. The most recent version of this fact sheet is included in Appendix II.

Currently, to provide a comparable measure to external stakeholders, the Australian banks publish both their APRA capital ratios and their internationally harmonised capital ratios. For Commonwealth Bank, the difference between our Common Equity Tier 1 capital ratio under APRA's standards and on an internationally harmonised basis as at 31 December 2013 is 2.9 percentage points (8.5% versus 11.4%, respectively).

Further, the Basel Committee has recently conducted a banking book risk-weighted assets review as part of its Regulatory Consistency Assessment Programme (RCAP). The preliminary results from a survey of 32 internationally active banks (including the major Australian banks) from 13 jurisdictions shows that, while APRA requires the Australian banks to apply a credit conversion factor of 100% for undrawn corporate exposures, most other jurisdictions allow their banks to apply a credit conversion factor<sup>54</sup> closer to 50%.

<sup>53</sup> Basel Committee on Banking Supervision, 'Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III regulations – Australia', March 2014, Annex 10.

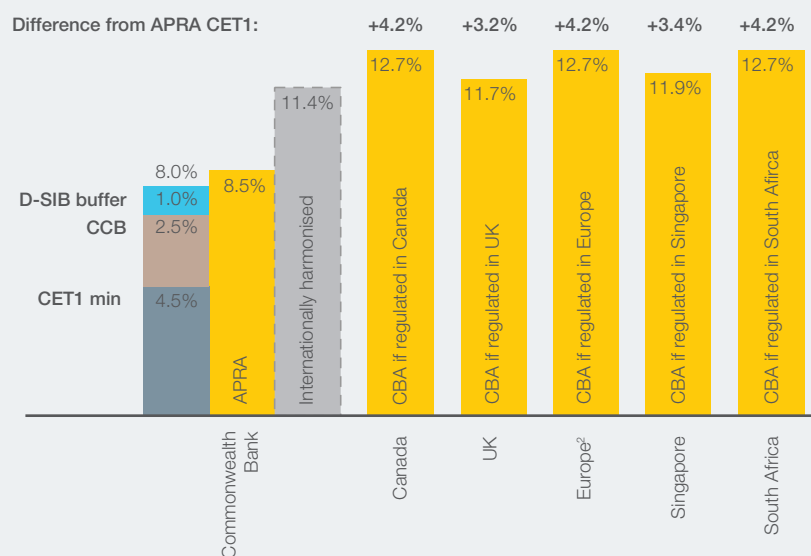
<sup>54</sup> A credit conversion factor is an estimate of the proportion of an undrawn corporate exposure which is expected to be drawn on default. This estimate is used to calculate the risk-weighted assets associated with the undrawn exposure.



This information led Commonwealth Bank, together with PwC and Morgan Stanley, to conduct an international survey of other regulators' application of the Basel standards. The survey found that there are a number of areas in which other regulators are less conservative than APRA, which benefits our international peers in the calculation of their capital ratios. The main areas are in relation to calculating the risk-weighted assets for corporate loans and the use of slotting for specialised lending. For further information about these, see Appendix I.

For Commonwealth Bank, the difference between our capital ratios under APRA's standards and calculated under the approach used in those jurisdictions is between 3.2 and 4.2 percentage points (Figure 21).

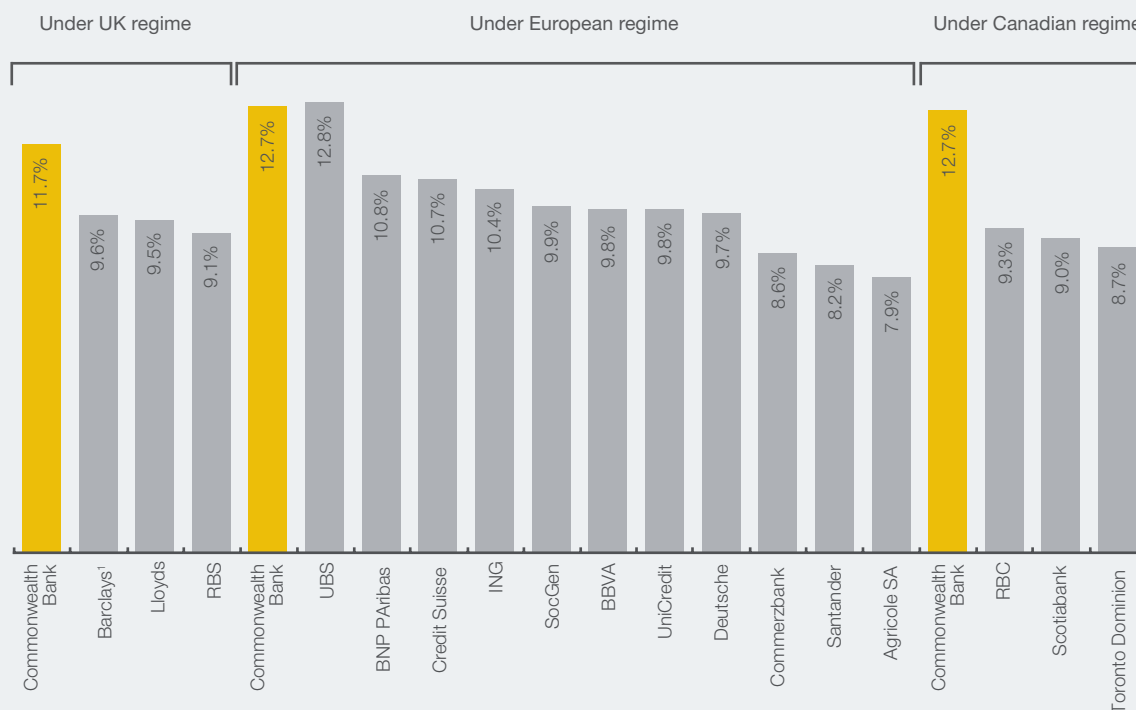
**Figure 21: Commonwealth Bank Common Equity Tier 1 ratio under various regulatory regimes<sup>1</sup>**



Source: Commonwealth Bank, PwC and Morgan Stanley. Morgan Stanley has reviewed the methodology used to calculate the impact in Canada, UK and Europe only.

Note: 1. Calculations under the non-APRA regimes include the impact of international harmonisation as well as adjusting for additional regulatory constraints imposed by APRA which are not required in those jurisdictions. 2. Based on CRD IV as implemented by the European Commission.

This makes Commonwealth Bank one of the most highly capitalised banks in the world (Figure 22).

**Figure 22: Commonwealth Bank versus peers in developed market jurisdictions**

Source: Commonwealth Bank, PwC and Morgan Stanley. Based on last reported CET1 ratios up to 7 February 2014 assuming Basel III capital reforms fully implemented.

Note: 1 Barclays includes impact of rights issue (120bp) settled on 4 October 2013.

### 3. PILLAR 2 ADJUSTMENTS AS A SOLUTION

The Basel capital framework is based on three pillars: a minimum capital requirement based on risk-weighted assets (Pillar 1); the potential for bank supervisors 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 calculation includes the conservatism discussed above and causes them to report lower capital ratios.

In contrast, bank regulators in other jurisdictions include local regulatory adjustments in the Pillar 2 adjustment.<sup>55</sup> The benefit of this is that it does not affect the amount of capital that those banks publicly report to meet their capital requirements for Pillar 1. This allows banks to report capital ratios with greater comparability across international peers, without constraining the ability of local regulators to modify capital requirements.

Commonwealth Bank **recommends** that local regulatory adjustments should be included in the Australian banks' Pillar 2 adjustment rather than in Pillar 1 calculations. This would allow the Australian banks to publish Pillar 1 capital ratios which are comparable with international peers. It would not diminish the amount of capital which the Australian banks hold to absorb losses but would more appropriately demonstrate the amount of capital available.

<sup>55</sup> A relevant example is the Swedish bank regulator (Finansinspektionen). In May 2013, the Swedish regulator announced the imposition of a risk weight floor of 15% on Swedish mortgages, which is applied through a Pillar 2 adjustment and does not impact reported capital ratios.

## CHAPTER 6: EMBED A SUPPORTIVE OPERATING FRAMEWORK FOR AUSTRALIAN BANKS

### SUMMARY

- The stability of Australia's financial system is supported by having four large, stable, prudently-managed institutions.
- APRA has introduced the Domestic Systemically Important Bank (D-SIB) levy which imposes extra capital requirements on these large banks to increase their ability to provide systemic support.
- However, there is a perception that Australia's banks benefit from an implicit Government guarantee and that large banks benefit disproportionately through a funding cost advantage. This perception is not supported by facts.
- There is general banking system support from the Government, including liquidity support measures, which provides advantages to the entire banking system, and in particular advantages smaller banks.
- There is a track record of the Government and regulators working with the large banks to resolve any small bank stress without depositor or bondholder loss.

### RECOMMENDATIONS

- As circumstances around failure of an individual bank will vary, Commonwealth Bank does not promote a prescriptive formula to deal with every situation.
- Liquidity support mechanisms such as enhanced central bank liquidity operations and bond guarantee schemes are important tools for stabilising the banking system in stress conditions. These liquidity support mechanisms are not 'bail-outs'.
- Liquidity support mechanisms should be supplemented with clear tools to support an orderly resolution of a failing or failed bank.
- These resolution mechanisms should preserve the order of seniority of lenders, and ensure that no creditor is worse off than in a conventional insolvency scenario.
- Pre-funded levies applied to the Financial Claims Scheme (FCS) are not currently required, and the need for the FCS as an ongoing measure should be reviewed.

### 1. IMPLICIT GUARANTEES IN THE AUSTRALIAN BANKING MARKET – THE PERCEPTION

Since the GFC, regulators and market participants have debated the concept of 'too big to fail' (TBTF) as it applies to financial institutions. The TBTF concept suggests that some financial institutions, as a result of their size and function in the domestic or global markets, are systemically important to the functioning of their domestic financial system or the broader global financial system.

These institutions typically participate in large cross-border activities as well as non-retail banking activity. During the GFC, some such institutions came under severe financial strain and required direct government funding to maintain function. These instances were in some public debates referred to as 'bail-outs', provided at high expense to taxpayers.

As a result of these actions in various jurisdictions globally, it is often suggested that large financial institutions receive an implicit government guarantee.

The IMF produced a country report on Australia in November 2012, which noted the systemic importance of Australia's major banks, and the expectations of the Basel Committee for more intensive supervision and higher capital requirements for systemically important institutions.

This report contributed to the market perception that Australia's major banks, including Commonwealth Bank, receive an implicit government guarantee against failure due to the potential adverse contagion impacts on the financial system. The report notes the perceived implicit guarantee may create funding cost advantages for major banks in Australia, and as a result, banks should bear some of the cost of mitigating systemic risk.

Governments play an important and natural role in mitigating systemic risk in financial systems, both domestically and internationally. The existence and economic benefits of an implicit government guarantee on certain financial institutions, however, are difficult to recognise or quantify.

Ratings agencies have developed methodologies which incorporate such support into bank ratings. For example, Standard & Poor's (S&P) rating methodology allows all rated Australian banks to benefit from its view of support from the Australian Government, which has a value of one notch.<sup>56</sup>

To the extent that the major banks receive additional uplifts (two notches) in their ratings, this occurs because S&P considers that the major banks are systemically important and therefore likely to receive additional or 'extraordinary' government support in a crisis situation. This benefit to systemically important banks is not unique to Australia or Australian banks. International peers such as Barclays (UK), Royal Bank of Canada (Canada), Wells Fargo (USA) and Nordea (Sweden) receive one notch of ratings uplift, while Deutsche Bank (Germany) and OCBC (Singapore) receive two notches of ratings uplift. In total, 77 of the top 100 global banks (by size of Tier 1 capital) rated by S&P receive ratings uplift for perceived government support.<sup>57</sup>

Commonwealth Bank believes that ratings agency methodologies which incorporate assumptions about the existence of and different degrees of an implicit government guarantee are subjective and not supported by historical market observations. During the GFC, financial markets did not recognise measurable value from a perception or otherwise of an implicit government guarantee. The correlation between credit risk for the major banks (including Commonwealth Bank) and the Australian Government was less than 10%<sup>58</sup> based on the risk measures derived from both the bond (e.g. asset-swap spreads)<sup>59</sup> and derivative (e.g. Moody's Analytics CDS market implied ratings)<sup>60</sup> markets.

Commonwealth Bank also believes that there is a questionable relationship between sovereign support (perceived or explicit) and the cost of funding.

This is demonstrated by RBS and Lloyds, which received large UK Government capital injections in October 2008 and November 2009 respectively. Despite being 83%- and 43%-Government owned respectively, the CDS<sup>61</sup> pricing of the banks diverges widely from the UK sovereign CDS (Figure 23). The two bank curves are more highly correlated with each other than with the sovereign curve. This suggests that the two banks receive little funding cost benefit despite the explicit government support.

56 This occurs under S&P's Banking Industry Country Risk Assessment (BICRA) for Australia. The BICRA is the starting point for the ratings for all Australian banks.

57 Standard & Poor's, 'Impact of Government Support on the Issuer Credit Rating of the Top 100 Banks Globally', 23 January 2014.

58 For the period January 2008 to March 2010.

59 Asset-swap spread is the difference between the yield of a bond and the BBSW curve. It is designed to show the credit risk associated with the bond.

60 Moody's Analytics CDS market-implied ratings are pure reflections of CDS market trading levels for both banks and sovereigns. They provide highly accurate point-in-time signals of default risk but are more volatile than traditional rating agency ratings which focus on a longer term and incorporate complicated methodology assumptions. Moody's Analytics is a research and financial modelling subsidiary that is separate from the traditional rating activities of Moody's Corporation.

61 CDS (credit default swap) are derivative transactions which enable hedging of the debt of the underlying entity. The cost of CDS is provided in bps and is a homogenous benchmark by which to compare issuer funding costs.

**Figure 23: CDS (5-year senior) pricing – RBS and Lloyds versus UK government**

Source: Bloomberg.

## 2. THE DIFFERENCE BETWEEN IMPLICIT GUARANTEES AND GENERAL GOVERNMENT SUPPORT

As demonstrated by the recent history of the Australian banking system described in Chapter 1, all banks have been considered ‘systemically important’ during crises. During the GFC, the following occurred:

- All banks had access to the Government guarantee of wholesale debt funding.
- All banks participated in the FCS, although it largely benefited smaller banks experiencing deposit outflows.
- The \$20 billion RMBS purchase program through the Australian Office of Financial Management (AOFM) was available to all banks. It was predominantly utilised by smaller banks, which were relatively more reliant on the securitisation market for funding.

Smaller Australian banks are more likely to fail than large banks during both stable and crisis periods. The point-in-time probability of default (PD) (also known as Expected Default Frequency) estimated by Moody’s Analytics for smaller banks is four times that for larger banks now<sup>62</sup> and was 30 times at the height of the GFC (March 2009).<sup>63</sup> However, when smaller banks have failed, the Government and regulators have facilitated orderly resolution in partnership with stable and well-capitalised larger banks.

Commonwealth Bank believes that there is a difference between implicit guarantees for particular institutions and general government support. **Commonwealth Bank does not believe that there is an implicit guarantee for the major banks but that there is general government support for the whole banking system. This has provided overall stability with broad benefits to the Australian economy.** The efforts of Government, regulators and large banks during the GFC allowed the Australian economy to maintain financial functions with no direct cost to taxpayers.

<sup>62</sup> December 2013 measure.

<sup>63</sup> This market-based measure of risk is calculated for a bank based on three factors: the market value of its assets, its volatility and its current capital structure rather than direct considerations of an implicit guarantee, which it captures by the way market participants act and by their actions implicitly price these assets. It is a widely used financial measure of risk.

### 3. PRACTICAL SOLUTION TO ADDRESS THE IMPLICIT GUARANTEE ISSUE

#### 3.1 Development of liquidity tools

Mechanisms which provide government support can raise questions over the actual nature of the mechanism, specifically which parties benefit and which parties bear the cost.

Market participants may mistake mechanisms to enhance liquidity as ‘bail-outs’ for insolvent banks by taxpayers. Rather, liquidity tools are designed to stop runs and panics, not to support insolvent banks. Measures taken in Australia during the GFC enhanced liquidity and stability while minimising funding disruptions resulting from financial system failures offshore. These mechanisms, summarised in Chapter 1, ensured that credit remained available on reasonable terms in the economy.

**Commonwealth Bank supports the development of tools which enable governments and central banks to continue to provide appropriate liquidity and stability support to financial systems.** These tools should not increase moral hazard<sup>64</sup> or provide bail-out support to individual banks.

The Government and regulators have been actively progressing a number of initiatives to provide liquidity and stability support. These initiatives include:

- Extending the time horizon for banks to cover their own liquidity outflows under stress via the introduction internationally of the Liquidity Coverage Ratio. This gives governments more time to assess a bank’s solvency before providing lender-of-last-resort funding.
- Increasing capital requirements for all banks to ensure a more resilient and stable financial system.
- Identifying systemically important institutions and imposing measures to reduce the probability and impact of their failure. This involves additional capital holdings, more intensive regulatory supervision, and ensuring these entities can be resolved in an orderly manner.

Commonwealth Bank supports the continued development and implementation of these initiatives in accordance with international guidance and timetables.

#### 3.2 The role of APRA

APRA has already identified the major Australian banks as D-SIBs and introduced additional capital requirements for these banks. These requirements are in addition to the conservative local regulatory adjustments applied by APRA (as discussed in Chapter 5).

Explicit resolution planning is yet to be implemented but APRA started recovery planning exercises with the six largest banks in 2011. APRA is considering the extension of this to resolution planning. The Treasury also commenced a review of APRA’s crisis powers, including orderly resolution capabilities, in November 2012. Commonwealth Bank **recommends** that these resolution powers are clarified during the review process, with a view to the following key functions:

- Limit contagion and instability impacts from a large or small bank failure.
- Ensure continuity of important financial services.
- Clarify perceptions of implicit government support and the implied contingent exposure on the government to provide bail-out support.
- Respond to ratings agency methodologies to appropriately address bank risk.

64 The most commonly accepted definition of moral hazard is ‘the possibility that you will take less care to prevent an accident if you are insured against it’. Source: Paul R. Krugman and Maurice Obstfeld, ‘International Economics - Theory & Policy’, 8th Edition, Pearson International Edition.

- Enable international investor transparency and confidence on the risk profile of Australian bank debt and equity relative to offshore peers, especially in light of ongoing regulatory trends for progressing orderly resolution tools internationally.
- Reduce incentives to unnecessarily increase capitalisation requirements and/or the supervision of banks in Australia relative to international jurisdictions.

Commonwealth Bank **recommends** that, during the review of APRA's functions, the reviewers note that circumstances around failure of an individual bank will vary, and a prescriptive formula to deal with every situation is likely inappropriate. Tools which are being developed internationally may not appropriately fit the Australian financial system, and any resolution tool must respect the order of seniority of lenders as would be applicable in a conventional insolvency.

Finally, **Commonwealth Bank does not support a tax or levy to reflect any implied government guarantee; it is better to remove any implication of a guarantee than to introduce another distortion in an effort to offset it.** Such a tax or levy would increase moral hazard by raising the risk that banks and their investors would feel entitled to taxpayer funds (that is, a 'bail-out').

Matters of resolution tools and bank structures are highly complex in nature and have implications across a wide scope of legal, governance, commercial, customer and regulatory areas. The characteristics of the national banking market and financial system are critical factors in the development of appropriate resolution plans. The experience in other jurisdictions has been that some of the most complex resolution issues have related to managing CDS and other derivatives where, in addition to discussion with the bank regulator, discussion with the central bank has been necessary. Cross-border derivative situations are particularly difficult, causing delays in resolution. Commonwealth Bank **recommends** that resolution plans are developed over time between the Australian banks and financial regulators, working together, to suit the Australian banking system's particular circumstances.

#### 4. FCS LEVY

In 2013, the then Australian Government proposed the FCS be changed from a post-funded to a pre-funded deposit scheme by the introduction of a levy on protected deposits of 5-10 bps per annum. This recommendation was based on comments and recommendations made by the IMF in the context of addressing moral hazard in a highly concentrated banking sector.

Commonwealth Bank does not support the proposed changes to the FCS scheme, specifically any pre-funded levy. The proposed changes effectively represent a deposit tax due to the remote nature of the risk of both:

- The insolvency of a highly capitalised Australian bank.
- Depositors as the most senior creditors suffering any net loss in the highly unlikely event of an insolvency.

The FCS does not currently impose any cost on the economy. Until the FCS is invoked and the appropriate cost is quantified, it is wrong to impose a levy.

Commonwealth Bank acknowledges the benefits of the FCS for financial stability and funding availability broadly in times of economic stress. However, taxes or levies may result in additional costs to borrowers and/or reduced returns for depositors. Any distortion that may reduce the deposit base in the banking system makes the system less stable.

Commonwealth Bank **recommends** that the ongoing role of the FCS in the Australian banking system be regularly reviewed. We do not support a pre-funded levy. Reviews may also consider altering the coverage of the FCS to better target the needs of retail depositors.

## CHAPTER 7: ENSURE AN APPROPRIATE FRAMEWORK FOR THE SHADOW BANKING SECTOR

### SUMMARY

- Risks to the financial system arise when non-bank financial institutions perform certain activities at scale that create concerns regarding solvency, precipitating a liquidity crisis. These risks must be managed to ensure the stability of the financial system.

### RECOMMENDATIONS

- Activities undertaken by the shadow banking sector that are typically subject to supervision when performed by traditional regulated institutions should be regulated.
- The Council of Financial Regulators (COFR) should continue to closely monitor shadow banking activities in Australia given the systemic risks and disruption potential created by these activities.

### 1. ISSUES WITH SHADOW BANKING

Shadow banking is credit intermediation, liquidity and maturity transformation, and leveraging activities involving entities wholly or partially outside of the regulated banking system. That is ‘many financial institutions that act like banks are not supervised like banks’<sup>65</sup> although they may be regulated with regards to securities, financial services or other regulation. The lack of prudential regulation (i.e. capital, liquidity and funding) represents a potential risk to financial stability.

Shadow banking can involve securitisation vehicles, asset-backed commercial paper (ABCP) conduits, money market mutual funds investing in commercial paper or mortgage-backed securities, markets for repurchase agreements (repos), investment banks, and mortgage companies. In Australia, these businesses currently represent a small segment of the economy. However, it has the potential to grow and drive increased systemic liquidity risk, particularly in times of crisis. These businesses, by being less regulated, offer less buffer of liquidity and less loss-absorbing capital. They are also subject to less governance and less public disclosure requirements with regard to credit intermediation and liquidity and maturity transformation activities than traditional banks.

Shadow banking activities are not disruptive when markets are operating ‘normally’ and an appetite for risky assets exists. However, problems arise when markets become concerned about the value of longer term assets held by shadow banks (and regulated banks). This can give way to concerns about the solvency of shadow banking entities given their limited loss absorbing capital. These concerns can trigger a liquidity crisis.

If the market loses confidence in shadow banking entities, this nervousness can rapidly spread throughout the rest of the financial system. Shadow banks are intertwined in the broader financial architecture, particularly through bank sponsorship of these entities and their holdings of short-term bank debt.


65 IMF, ‘What Is Shadow Banking?’, Finance & Development, Vol. 50, No. 2., June 2013.



## 2. MANAGING THE RISKS OF SHADOW BANKING

Commonwealth Bank **recommends** that the principle of regulatory neutrality apply to shadow banking activities. Regulators should be informed by the risk an institution or activity represents and regulate accordingly, and should be aware of cyclical trends as shadow banking may be able to develop more quickly at various points in the cycle. Activities undertaken by the shadow banking sector that are typically subject to supervision when performed by traditional regulated institutions should be regulated in a similar fashion. In particular, activities which are effectively the taking of deposits should only be conducted by prudentially-regulated banking entities.

Commonwealth Bank **recommends** that the COFR continue to closely monitor shadow banking activities in Australia given the systemic risks and disruption potential created by these activities. Regulators should, consistent with the risk it represents, develop and apply appropriate regulatory frameworks to the sector's activities.

A man with a beard and glasses, wearing a blue button-down shirt, is smiling and holding a large silver wrench. He is standing in a workshop with blue and yellow equipment in the background. A red toolbox is visible in the lower left corner.

**CUSTOMERS  
MUST BE  
OFFERED  
THE SAME  
PROTECTION AND  
SECURITY BY  
NEW PLAYERS  
THAT THEY  
RECEIVE FROM  
TRADITIONAL  
BANKS.  
COMMBANK CAN.**

# SECTION III:

# PROTECTING AUSTRALIANS

# IN THE DIGITAL ECONOMY

## CHAPTER 8: ADJUST SETTINGS FOR TECHNOLOGICAL CHANGE

### SUMMARY

- The value of the digital economy has grown exponentially since the Wallis Inquiry. Technological change and digital innovation have transformed the delivery of financial services and heightened competition with tangible benefits for customers, while bringing productivity benefits to the overall economy.
- Technology development and understanding a customer's financial needs will allow financial institutions to provide faster, more convenient and more personalised services relevant to that customer's life stage.
- New technologies introduce potential risks. A balanced approach must be taken to regulating digital delivery of financial services which encourages innovation and competition whilst ensuring the integrity, stability and security of the financial sector. Customers and their data must be protected.
- Commonwealth Bank has identified issues that may prevent the digital economy from reaching its full potential:
  - New technologies have allowed non-bank entities to provide bank-like and finance-related applications and services without necessarily being regulated the same way as traditional banks. This lack of regulatory consistency increases the risk to customers and to the stability of the financial system.
  - Customers currently maintain multiple online identities, which creates online inefficiency, increases the risk of fraud and undermines trust in online interactions. Broader availability and more effective use of secure digital identities will underpin trust and value in the digital economy.
  - Australia's national cyber security strategy has not been updated since 2009, in an environment characterised by increased cyber threats and more sophisticated cyber-adversaries.
  - Australian industry, and therefore consumers, may not fully realise the potential benefits of cloud computing if regulatory approaches do not carefully weigh encouraging innovation with mitigating privacy and security risks.
  - Few Australia-based start-ups scale to sustainable businesses.
  - Regulations and industry codes on disclosure have failed to keep pace across all methods of disclosure, especially for 'electronic disclosure'.
  - The pace of technological change represents a challenge to the current capacity and dynamics of the IT workforce.



## RECOMMENDATIONS

- Consistent regulations should be extended to all financial system functions to protect customers and preserve trust whilst encouraging innovation. This includes Know Your Client (KYC), Anti Money Laundering (AML), Suppression of Terrorism Financing (STF), capital and liquidity regulations as appropriate.
- Review the importance of digital identities and consider the development of a financial system-led policy framework.
- Australia's national cyber security strategy should be updated with a focus on private-public sector co-operation to ensure continued cyber security resilience across the financial services industry and critical infrastructure sectors.
- A regulatory approach that carefully balances the utility and benefits of cloud computing against privacy and security risks should continue to be maintained. This approach must continue to be risk and principles-based.
- Financial services disclosure requirements should be modernised to be technology neutral while still accommodating disclosure for products not designed exclusively for electronic use.

### 1. TECHNOLOGY CAN IMPROVE CUSTOMERS' FINANCIAL LIVES

At the time of the Wallis Inquiry in 1997, the internet and internet banking was in its infancy, with less than 16% of Australian households having internet access.

Since 1997, the digital economy has grown exponentially. Now, over 83% of Australian households have internet access while broadband penetration and the uptake of mobile devices is accelerating development of the digital economy.<sup>66</sup>

The internet has directly contributed to growing the Australian economy. In 2010, the digital economy contributed approximately \$50 billion to GDP. This contribution is predicted to grow on average 7% annually through 2015,<sup>67</sup> nearly double the growth rate in the rest of the economy.

The benefits to Australian consumers from technology innovation and the added competition that it brings are tangible. For example, Commonwealth Bank makes extensive efforts to understand customers' relationships to their finances and the role that technology can play in managing their financial lives. Our in-depth research tells us that customers have a core set of needs: confidence via education to support their decision making; control over what can often be complex and uncertain issues; transparency and trust with their financial services providers; and the ability to connect with people to assist, including in a digital environment.

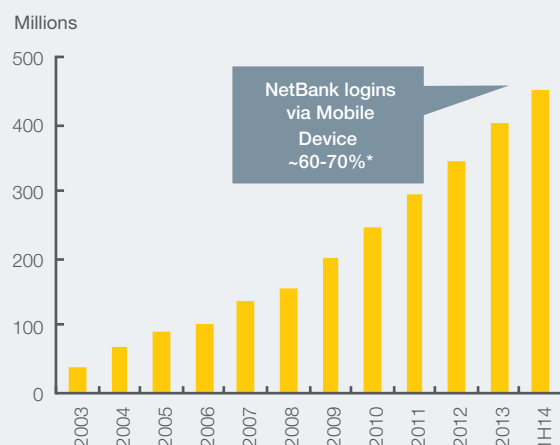
Commonwealth Bank strives to use these insights to meet customers' needs through the technological assistance we provide to manage their finances. We aim to build deep relationships with customers and to meet their needs in a way that is personalised and contextual for their stage of life. We discuss the importance of the financial system responding to customers' life stages in the context of financial literacy in Chapter 13.

66 ABS, 'Household Use of Information Technology', 25 February 2014.

67 Deloitte Access Economics, 'The Connected Continent - How the internet is transforming the Australian Economy', August 2011.

Commonwealth Bank was the first major Australian bank to offer online banking with the launch of NetBank in 1997. In financial year 2013, Commonwealth Bank processed more than 400 million transactions via the internet, of which over 60% of NetBank logins were via mobile devices (Figure 24). In December 2013, Commonwealth Bank launched its new CommBank smart phone application. Since then, a million people have downloaded the app. For 40% of people using this app, it is the only way they now interface online with Commonwealth Bank. The CommBank App is the most recent in a long history of digital innovations by Commonwealth Bank (Figure 25).

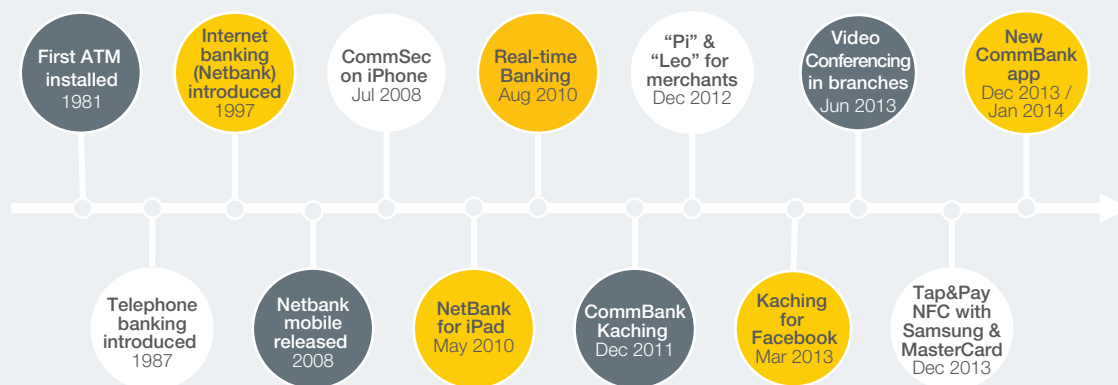
**Figure 24: Commonwealth Bank number of internet transactions**



Source: Commonwealth Bank.

Note: 1H14 is annualised. Calendar years to 2007; financial years thereafter. Includes BPAY, tablet and mobile, December 2013.

**Figure 25: Commonwealth Bank innovation timeline, 1981 to 2014**



Source: Commonwealth Bank.

New technologies and innovations introduce potential risks that can inhibit the digital economy from reaching its full potential. Secured handling of customer data is paramount to maintaining customers' trust in the system to enable ongoing digital innovation.

Commonwealth Bank **recommends** a balanced approach to regulating digital delivery of financial services that encourages innovation and competition whilst ensuring the integrity, stability and security of the financial sector.

## 2. EXTEND CONSISTENT REGULATIONS TO ALL FINANCIAL SYSTEM PARTICIPANTS

Advances in technology have led to an increase in the production of personal data. Growing consumer awareness of the value of and risks to their data has led to increased expectations of privacy and security from online services.

Trusted financial institutions such as ADIs are subject to a range of regulatory requirements and industry codes that ensure customer privacy and security. These are in addition to privacy laws that apply generally within the private sector. This has ensured that the Australian banking and finance sector is perceived by consumers as trusted. For example, a 2013 Australian survey of community attitudes to privacy found 74% of respondents trusted financial institutions based on their handling of personal information (the second-highest ranked industry after health service providers).<sup>68</sup> Maintaining and enhancing the actual and perceived level of trust associated with Australian financial services is critical. The industry needs to ensure that it safeguards itself from trust issues that continue to feed concerns in other contexts about privacy protections both domestically<sup>69</sup> and internationally.<sup>70</sup>

Technology has enabled non-bank entities to provide bank-like and finance-related applications and services. Not all competitors are subject to the same level of regulation. ADIs are subject to comprehensive regulation which compels them to, among other things, maintain sophisticated operational risk controls under mandated risk management frameworks. Key parts of these frameworks are KYC, AML, and STF requirements. In turn, this leads to significant ongoing investments in security and privacy infrastructure. ADIs are also subject to broad ranging capital and liquidity requirements. The requirements may not apply to the same extent to new entrants which operate in financial market niches.

This uneven playing field poses a risk to customers' finances and personal information, as well as to the stability and reputation of the system. This in turn may increase costs for ADIs and customers.

While innovation in the system must be encouraged, allowing new players to enter an uneven playing field distorts the market. This may discourage entities which invest in the safeguards mentioned above from making the investments that have to date improved the system for customers while maintaining its stability.

Australian customers must be offered the same protection and security by new players that they receive from traditional banks. This is especially critical as many businesses increasingly use advanced data analytics on large data sets ('big data') to deliver more tailored services and products. The use of big data to provide insight into a customer's preferences must be carefully balanced with a customer's right to privacy and existing obligations businesses face in the handling and treatment of such data.

Commonwealth Bank has taken significant steps to ensure it complies with best practice privacy and data requirements. Commonwealth Bank has invested heavily in information security and a 'Privacy by Design' framework, which advises about the responsible management of all classes of personal information, particularly the output of big data analytics. The framework consists of Commonwealth Bank-wide privacy governance and a dedicated team of subject matter experts. The team uses privacy impact assessments (PIAs) to assess potential data uses within the organisation and to ensure it is handled appropriately and in a compliant manner.

---

68 OAIC, '2013 Community Attitudes to Privacy', October 2013.

69 For example, on 12 June 2013 the Australian Law Reform Commission was given Terms of Reference for a new inquiry into the protection of privacy in the digital era: see ALRC, 'Serious Invasions of Privacy in the Digital Era', Issues Paper 43 (<http://www.alrc.gov.au/>).

70 See for example the European Parliament calling on 12 March 2014 for an immediate suspension of EU-US privacy safe harbor principles and also voting to strengthen the EU privacy framework amidst ongoing concerns about privacy in the digital age.

Whilst the use of PIAs has not been mandated in regulation, the Office of the Australian Information Commissioner (OAIC) has published its PIA Guidelines to encourage uptake of PIAs as standard best practice in the corporate sector.

Commonwealth Bank **recommends** non-bank entities and limited-purpose ADIs participating in the financial system be subjected to the same regulation as traditionally-regulated institutions and that the Government continue to promote best practice guidelines on privacy and data security.

This should involve the following:

- Extend principles contained in regulation and financial industry codes to non-bank participants.
- Ensure that the same level of supervision and monitoring is applied to all industry participants. Where appropriate, KYC, AML, STF, capital and liquidity regulations should be applied.

### 3. ENCOURAGE TRUSTED DIGITAL IDENTITIES

The digital economy presents enormous potential value for businesses, governments and individuals, including lower prices, added convenience and richer experiences.

However, the present need for individuals to maintain multiple online identities creates inefficiency and a burden for all parties. Individuals either suffer the inconvenience of managing multiple passwords or risk fraud and identity theft from re-using identities across multiple services. The proliferation of online identities means businesses and governments that provide online services cannot easily trust individuals seeking to do business with them, and must also manage multiple repositories of sensitive customer identity.

These burdens can inhibit the digital economy from fulfilling its potential – as much as two-thirds of value generation<sup>71</sup> is at risk if there is not a trusted flow of data. Offering individuals the opportunity to use a trusted digital identity to access a range of online services will enhance their online experience and improve trust, security, privacy and productivity.

The importance of improving trust and security around digital identities has been recognised in overseas jurisdictions, such as via the US Government's National Strategy for Trusted Identities in Cyberspace (NSTIC).

In Australia, there is a risk that customers will be impacted by inefficiency and security threats if the proliferation of identities across expanding digital 'footprints' continues on its current track. The private sector has an important role to play in addressing this risk, particularly the financial sector as the primary providers of secure and private digital identity solutions.

Commonwealth Bank **recommends**:

- The Inquiry reviews the importance of digital identities in the financial system in the context of the growing role of technology in meeting customer needs. The Inquiry should consider whether a financial system-led national policy framework or strategy for trusted digital identities should be developed. Commonwealth Bank is a leader in bringing the convenience advantages of technology to customers but is also focused on the need to maintain trust, security and privacy. We are keen to play a leading role in discussions on this topic.
- Extended rollout of electronic verification services such as Document Verification Service (DVS), increasing the security of online registration and transactions.

<sup>71</sup> Boston Consulting Group, 'The Value of Our Digital Identity', November 2012. Current and potential economic value of digital identity, based on value that consumers place on their personal information and how they make decisions about whether or not to share it.

#### 4. ENSURE NATIONAL CYBER SECURITY RESILIENCE

Delivery of financial services in Australia is generally safe and system fraud losses are rare, with customers typically reimbursed when cybercrime losses do occur. Innovation in the Australian financial system has not occurred at the expense of security or resilience. Security-related technologies such as SMS 2-factor authentication have been implemented and have been well-received by customers.

Whilst the financial system is reasonably secure, the broader and longer term view of the cyber environment is negative. The capability of those posing cyber threats (nation states, criminal groups, and politically motivated ‘hacktivists’) continues to evolve, while recent US government surveillance revelations have adversely impacted online trust. These factors could undermine development of the digital economy.

Australia’s cyber security strategy has not been revised since 2009. In the meantime, the threat to Australians online has increased and Australians have become even more reliant on the internet as part of their daily lives. A re-evaluation of Australia’s cyber security strategy and program of investment would be timely.

Governments in other major markets have prioritised cyber security, investing heavily in operational and policy development including public-private partnerships (PPPs).

Commonwealth Bank **recommends** an update of Australia’s cyber security strategy based around the following pillars:

- Reviewing the scope, breadth and distribution of Australian cyber security investment in the context of the critical role it plays in the Australian digital economy.
- Promote greater public-private sector cooperation and partnership on matters of cyber security, including the active and real-time sharing of information and intelligence.
- Formalise roles, responsibilities and protocols in the event of a cyber-crisis. Private sector owners of critical infrastructure will be responsible for defending their own systems in the first instance, until an attack exceeds the pre-defined levels or norms.
- Explore government incentives for private sector investment in cyber security, which can drive a widespread lift in security standards and practices across entire industries and critical infrastructure sectors.
- Advocate internationally for internet policy and governance settings that will enable growth of the digital economy. Advocacy should aim to preserve an open digital economy with free flows of information across borders, derived from a clearly articulated and shared national vision for the future of the internet.

#### 5. ESTABLISH PRINCIPLES-BASED REGULATORY SETTINGS FOR CLOUD COMPUTING

Cloud computing presents opportunities for individual businesses while enabling innovation more broadly in the digital economy. It allows organisations to more rapidly employ computing resources to meet changing demand, enjoy lower infrastructure costs, and more easily access data and applications.

The extent to which the economy realises the potential of this rapidly-developing technology is uncertain. Pursuing the policy objective of security of infrastructure and customers’ data is critically important; therefore, it is appropriate that APRA is developing guidelines for the use of cloud computing in the financial system. It is important, however, that the boundaries placed around the use of the new technology remain flexible so as to not restrict the benefits that cloud capabilities can deliver to customers.



Commonwealth Bank **recommends** a balanced regulatory approach to cloud computing that weighs the utility and benefits of these new technologies for consumers and businesses against the privacy and security risks. As new standards and regulations are explored, outcomes will be best achieved via a continued risk and principles-based approach.

## 6. ENCOURAGE DIGITAL INNOVATION

Digital innovation in the Australian financial sector has been strong and has delivered tangible benefits for Australian consumers. The sector has been a leader in adopting emerging technologies and trends including cloud computing, mobile applications and social media. Many of these innovations have been led by start-up businesses.

However, few Australia-based start-ups successfully scale to sustainable businesses. Challenges include the lack of support for new idea generation from science and innovation research.

Government has a critical role to play in fostering and encouraging the development of a thriving local technology community that can further enhance the growth of the financial services sector through technology innovation.

Commonwealth Bank suggests increasing investment and support for research in science and innovation, including through the National ICT Australia (NICTA) and CSIRO models, as well as for private incubators. Encouraging closer research ties between academia and industry is a key factor in boosting the number and quality of innovative ideas and products entering the Australian economy.

Financing for SMEs and start-ups in particular is discussed further in Chapter 15.

## 7. MODERNISE CONSUMER DISCLOSURE REQUIREMENTS

The foundation of disclosure regimes is the provision of information to consumers in a form that can easily be accessed, stored and retrieved if necessary.

However, the current regulatory framework results in document-centric requirements,<sup>72</sup> with allowance (more recently) for electronic disclosure.<sup>73</sup> The regulations and industry codes do not accommodate the variety of methods by which customers engage with financial services providers. In many cases, disclosure material are required to be 'given' or 'sent' to a customer by physical posting, or by means of electronic delivery to their addresses. Such a framework does not recognise the manner in which technology can better enable customers to access required information.

Technology would allow the applicable disclosure requirements to be satisfied in non-documentary forms and in ways which will assist in improving customer engagement and understanding.

For example, smart phone users can receive videos and voice memos and, once stored or hosted, can be accessed at any time in the future. It is also possible to provide consumers with links to content on social media platforms, with required information to consumers which can be viewed from any device.

Commonwealth Bank supports the continued use and effectiveness of electronic disclosure, which promotes more interactive engagement with customers, improves financial literacy and facilitates faster and more convenient services.

<sup>72</sup> Disclosure involved either a paper document or an electronic copy of a paper document, for example, a Financial Services Guide is required to have a 'cover' and statements on the 'front of' the applicable 'document'. S940C(1)(b) Corps Act.

<sup>73</sup> Commonwealth Bank acknowledges that the existing legislative frameworks and industry codes generally accommodate the use of disclosure by electronic means (Guarantor disclosure under the National Credit Code generally excepted). This is typically subject to the prior consent of the consumer. Furthermore, in some cases changes have been introduced to deal with new methods of electronic disclosure (such as hyperlinks for the provision of Financial Services Guides and Product Disclosure Statements).

Commonwealth Bank believes the law should be ‘technology-neutral’,<sup>74</sup> so long as applicable information can be accessed by consumers and, where appropriate, is available for retrieval. Mechanisms can be built in to preserve the current ‘sent’ or ‘delivered’ concepts.

A technology-neutral philosophy should also be adopted in circumstances where consumers are required to give consents, elections or confirmations to financial organisations. Consumers should not be compelled to provide these in ‘writing’ when there are numerous technological equivalents (such as recording a decision orally which can be verified subsequently).

Commonwealth Bank **recommends** that a review of the relevant disclosure provisions and industry codes is conducted, specifically the requirements of Chapter 7 of the Corporations Act and the National Credit Code for credit guides. The aim of the review should be to deliver a uniform and technology-neutral approach to disclosure, which accommodates for new functionalities and for products not designed exclusively for electronic use. Such disclosures may include use of RSS feeds, email, and system notifications for communicating content such as changes to terms and conditions or product features.

## 8. DEVELOP A SKILLED DOMESTIC IT WORKFORCE

Whilst not specific to the financial system, the long term development of cyber skills is crucial to ensuring Australian IT professionals are well placed to continually contribute to Australia’s digital future. This will positively influence the digital financial services sector.

The evolving cyber security landscape represents a challenge to the current capacity of the IT workforce and will require long term investment in the domestic IT workforce. This will include training on the most relevant skills including cyber security and higher value-added services.

In framing Australia’s national education policy, the Government, in conjunction with State and Territory Governments, can play a crucial role in nurturing the skills necessary to prepare industry and government for the digital future.

Partnerships with industry will be important. In the US, initiatives such as the ‘Partnership for 21<sup>st</sup> Century Skills’ bring together business, education and policymakers to promote skills in school education. The UK Government’s 2013 Information Economy Strategy likewise fosters collaboration between industry and educational institutions on a range of initiatives, including the creation of online courses to extend access to technology skills training. Commonwealth Bank would be pleased to participate in the development of similar initiatives.

Commonwealth Bank suggests:

- Policy settings that encourage more investment in skills and training to meet current and future needs.
- Partnerships between government, industry and academia to promote the development of a greater number of and improved university, technical and further education (TAFE) courses, and to further champion the IT profession as a career of choice across ethnic backgrounds and gender groups.

---

<sup>74</sup> Neutral as to the form of technology used and the form of the material.

## CHAPTER 9: ENSURE STABILITY OF THE PAYMENTS SYSTEM

### SUMMARY

- The payments system is crucial to the proper functioning of the economy and relies upon parties to a transaction trusting the integrity of the system. The security and stability of the payments system is paramount. Since the Wallis Inquiry, the payments system has been subjected to extensive regulatory oversight.
- The payments industry has delivered considerable innovation recently. The emergence of new payments system participants outside of the regulatory framework of the RBA and APRA introduces new risks to the system and requires attention to ensure the stability of the payments system is not compromised.
- Digital currencies have sparked considerable interest and attracted a community of users. However, the recent collapse of the largest Bitcoin exchange globally underscores the dangers posed by digital currencies. As yet, there is no consensus globally amongst regulators about how to treat digital currencies. The development of digital currencies needs to be closely monitored and regulated where necessary.
- Cheque usage is in terminal decline. This requires forward-looking and proactive management.

### RECOMMENDATIONS

Recommendations for regulatory oversight:

- Oversight and regulation of payments remains the responsibility of the Payments System Board (PSB).

Recommendations for addressing emerging challenges:

- The PSB to commit to oversight and regulation in a manner that is consistent across similar products and services, rather than according to clearing system or institution type.
- AUSTRAC to monitor non-ADIs, emerging payments service providers and digital currencies to ensure compliance with KYC and AML provisions.
- The RBA to formally extend its guidelines for reporting of operational incidents in retail payment systems to all significant payments system participants.
- APRA to reassess Purchased Payment Facility (PPF) regulations and conditions in line with the stricter provisions for ADIs brought about by Basel III.
- Non-ADI providers of payment facilities be required to disclose their regulatory status to all new and potential customers, and how they differ from ADI status.

#### Recommendations on appropriate treatment of digital currencies:

- The PSB to monitor developments in digital currencies and report its ongoing findings in its Annual Reports. The PSB should be prepared to designate and regulate digital currencies if found appropriate.

#### Recommendations for managing cheques' future:

- The PSB to set a multilateral interchange fee on cheque payments. This should be complemented by an education campaign to inform organisations that they are allowed to charge a pre-disclosed cost-based fee to recover their cost of accepting a cheque payment.
- All Australian Federal, State and Local Governments to phase out making payments by cheque; and either phase out acceptance of or impose a surcharge for receiving cheque payments. All governments to promote transition to electronic payments.
- The Federal Government to help educate Australian businesses about the efficiencies of electronic payments over paper-based payments.
- The PSB to consider and report on the future of cheques in Australia.

## 1. REGULATING THE PAYMENTS SYSTEM

The payments system enables the circulation of money through the economy. Users transact in the expectation that they will receive value from their counterparty. Anything that causes payment recipients to doubt that they will receive the value they are owed from a transaction could interrupt the entire payments system, with potential consequences for trade and the economy itself. A payments system needs appropriate oversight and regulation to prevent fraud, operational failures and other risks from undermining its smooth functioning.

Australia has a strong regulatory framework to govern and protect its payments system. The PSB was established in 1998 at the recommendation of the Wallis Inquiry to govern the payments policy work of the RBA. Since that time, the RBA has been active in both overseeing and regulating the Australian payments system. Key actions have included the following:

- Designating EFTPOS, Visa and MasterCard as being subject to its regulation.
- Imposing and subsequently revising interchange fee standards for credit and debit cards, allowing card transaction surcharging, prohibiting Honour All Cards Rules,<sup>75</sup> and imposing access regimes on card schemes in conjunction with a new classification of scheme participants.<sup>76</sup>
- Imposing an ATM access regime and introducing ATM direct charging.

Beyond this, the RBA conducted a review into its own payments system reforms and later established a review of innovation in the payments system.

The PSB set the payments industry five strategic objectives in its conclusions to its Innovation Review. The first of these, same day settlement of direct entry payments, was completed by the industry on schedule in 2013. The remaining four objectives relate to real time payments capabilities. These objectives are being addressed by the industry as a collaborative group via development of infrastructure known as the New Payments Platform (NPP).

<sup>75</sup> Rules which require merchants accepting a scheme's credit cards to accept their debit cards, and vice versa.

<sup>76</sup> Specialist Credit Card Institutions.

NPP is due to commence operation in 2016. NPP will consist of basic infrastructures to facilitate payments and numerous overlay services offering payment services to members and their customers.

NPP has the potential to transform the Australian payments industry by offering not only a range of improved payments functions which addresses current limitations, but also by offering simpler access to existing and new industry participants. NPP will facilitate the following payment functions:

- Process direct credit payments<sup>77</sup> in near real time.
- Address payments without knowing the recipient's account number and BSB.
- Include remittance data within a payment.

To achieve the full network benefits from real time payment services, NPP will require industry-wide participation by ADIs and, in parallel, real time posting to the accounts of payers and receivers of funds. Competition is likely to provide this outcome and spur ongoing investment by participants. However, the RBA should monitor developments and be prepared to intervene if there is a lack of participation amongst ADIs, or a lack of real time posting at the customer level, undermining the benefits to consumers from ubiquitous real time retail payments.

Real time payment provides the added benefit of eliminating settlement risks in the banking system arising from batch settlement. Currently, Commonwealth Bank bears the credit risk to other ADIs as a result of posting funds from payments to its customers' accounts prior to settling for the transaction with the payer's ADI.

The PSB has also proposed the formation of an industry governing body to coordinate industry initiatives affecting the payments system and to liaise with the PSB. Directors appointed to this body will represent a broad constituency and will be compelled to act in the interests of both the industry and the public. The Australian Payments Clearing Association (APCA) is currently working on the formation of a Payments Council to achieve this objective.

The PSB has embarked upon a new approach by setting the payments industry strategic objectives and initiating the formation of an industry body to liaise directly with the PSB and the RBA. More time is required to determine whether this new industry body and the PSB's setting of strategic objectives are successful.

Commonwealth Bank **recommends** that oversight and regulation of payments remains the responsibility of the RBA, governed by the PSB. It has acquired considerable knowledge and suitably skilled staff to fulfil its responsibilities. No other existing organisation is better suited to performing this role.

## 2. ADDRESSING EMERGING CHALLENGES

### 2.1 Context

The internet and smartphones have changed the way Australians pay for goods and services, and the NPP and faster broadband are likely to facilitate many new payments innovations that are yet to be conceived.

Options for moving outside of regulated payment systems are growing as a result of innovation. Examples include closed loop payment systems, international money transfer services and digital currencies. These pose emerging challenges and risks to the payments system.

---

<sup>77</sup> Only direct credits made via the NPP will be capable of being processed in near real time. Direct credit payments made via the pre-existing Bulk Electronic Clearing System will be processed as per their existing schedule.

Reduction of existing levels of security cannot be accepted because fraudsters will quickly capitalise. Any new risk and associated cost imposed upon the payments system is borne by its existing users and participants. Regulators must be vigilant in managing the risks introduced to the payments system by new and innovative payment offerings.

## 2.2 Regulatory approach for similar products

The RBA's approach to regulation of the payments system to date has been to regulate payments according to clearing system or institution type. This has been acceptable while electronic payment has been in its infancy. However, as innovative payment options using new technology rapidly emerge and distinctions between card and peer-to-peer (P2P) payments blur, it is important that the RBA adjusts its approach to payments regulation.

It is important that similar products are regulated consistently regardless of their technology platform or service provider. To do otherwise would risk stunting certain components of the payments system while advantaging other payments services. It also risks allowing new participants to introduce vulnerabilities to the payments system. Such an arbitrary handicapping of certain system participants will not deliver an efficient payments system shaped by competition and customer preference.

Commonwealth Bank **recommends** the PSB review its approach to regulation and commits to oversight and regulation of the payments system according to products and services with similar functions and features instead of by clearing system or institution type.

## 2.3 Know Your Customer (KYC) and Anti-Money Laundering (AML)

Australian ADIs and other financial service providers are subjected to KYC and AML legislation. The stability and integrity of the Australian banking and payment systems will be undermined if financial institutions are able to operate without applying KYC and AML provisions.

Commonwealth Bank **recommends** that AUSTRAC monitors non-ADIs, emerging payments service providers and digital currencies to ensure they are compliant with KYC and AML provisions.

## 2.4 Retail payments incidents reporting

The RBA requires Reserve Bank Information and Transfer System (RITS) members to report to the RBA on outages and operational incidents within the retail payments system meeting certain criteria.<sup>78</sup>

While the RBA's reporting criteria is quite rigid with low reporting thresholds, it covers only a minority of payments industry participants with similar product offerings and IT infrastructure and exempts all non-RITS members from reporting. It does not capture providers of smaller or newer payments services who may not have in place the same levels of monitoring and redundancy that large ADIs have invested in.

Commonwealth Bank **recommends** the RBA formally extends its guidelines for reporting of operational incidents in retail payments systems to all significant payments system participants. This will provide a complete view of the operational stability of the entire payments system, across all types of participants.

## 2.5 Purchased Payment Facility (PPF) regulations

APRA has designed the classification of a PPF to provide regulatory protection for non-ADI providers and users of payments systems based on purchased credits. This exempts providers of closed loop payment systems who do not have a broader banking business from the onerous provisions associated with ADI regulation.

---

78 RBA, 'Operational Incidents in Retail Payments Systems: Conclusions', November 2012.

Since the introduction of PPF regulation in Australia, the Basel III framework has been devised. Basel III requires financial institutions to hold more capital and sufficient high quality liquid assets to cover its anticipated net cash flows over 30 days.

Commonwealth Bank **recommends** APRA reassess its PPF regulations and conditions in line with the stricter provisions for ADIs brought about by Basel III. This would afford customers with balances held at a PPF a level of protection nearer to customers of ADIs.

## 2.6 Disclosure of non-ADIs' regulatory status

Users of non-traditional payments systems may not appreciate the differences between depositing money in an ADI account and storing funds with a non-ADI payments provider. In particular, it should be made clear to such users that their funds are not protected under the FCS nor do they benefit from depositor preference. Further, the dispute resolution process and insolvency payout prioritisation and provisioning should be explained.

Commonwealth Bank **recommends** non-ADI providers of payment facilities be required to disclose their regulatory status and how it differs from ADIs to all new and potential customers.

## 3. MONITORING DIGITAL CURRENCIES

The emergence of digital currencies, led by Bitcoin, has brought to life the prospect of alternative currencies to central bank-issued currency. While Bitcoin is a cost efficient system, its conversion rate volatility, the recent bankruptcy of a major Bitcoin exchange, security challenges and facilitation of payments for illegal activity creates instability and poses a risk to the payments system and the economy.

As yet there is no consensus globally among regulators about how to treat digital currencies. Consequently, the legal status of Bitcoin varies markedly between jurisdictions, with some countries viewing Bitcoin as a currency, while some others treat it as a commodity. Recently the New York Finance Department has stated publicly that it is considering introducing a regulatory framework for digital currencies.<sup>79</sup>

Anecdotally, Bitcoin does not seem to have broad acceptance within the merchant community. However, valid concerns exist about the usage of digital currencies for payments related to illegal activities due to the anonymity afforded to users. The risk of an unregulated new digital currency and companion payments system is that illegal activity may flourish by avoiding the safeguards contained in the banking system.

The recent collapse of the Mt Gox Bitcoin exchange has heightened concerns about the risks and instability introduced by digital currencies. Mt Gox was the world's largest Bitcoin exchange, handling an estimated 70% of all transactions. It filed for bankruptcy in February 2014.<sup>80</sup> Mt Gox has ceased operating and its clients have lost approximately US\$500 million worth of Bitcoins with little prospect of recourse.<sup>81</sup> Both the anonymity of Bitcoin holdings and the lack of regulatory oversight have enabled this security lapse and/or fraud to take place.

Commonwealth Bank **recommends** the PSB maintains a watching brief on developments in digital currencies and their regulation in overseas jurisdictions. The PSB should carry out the following:

- Decide whether it considers a digital currency to be a currency in a legal sense.
- Be prepared to designate and regulate digital currencies, if found appropriate.
- Publish its ongoing findings in the PSB's Annual Reports.

79 The Telegraph, 'New York Takes First Step To Regulating Bitcoin', 28 January 2014.

80 The Economist 'Bitcoin's woes: Mt Gox', 25 February 2014.

81 Task, A., Daily Ticker, 'Bitcoin needs to grow up if it wants to survive Mt. Gox collapse', 28 February 2014.

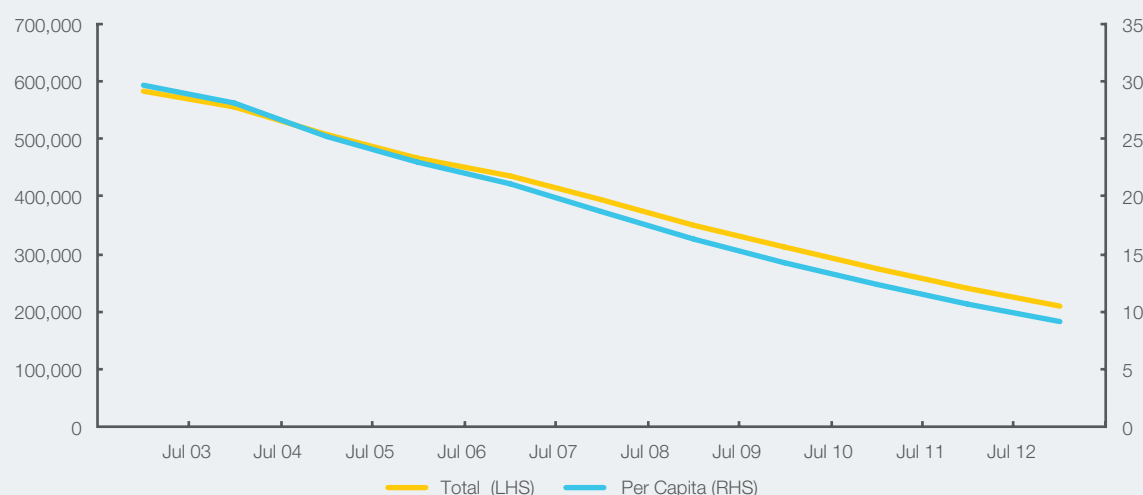


## 4. MANAGING THE FUTURE OF CHEQUES

### 4.1 Issues

Cheques are costly as a payment mechanism. In a 2007 study into payments costs in Australia, the RBA found the per-unit cost of a cheque payment to be \$5.17.<sup>82</sup> This per unit cost would have risen since 2007 as the volume of cheques has fallen by 54% (Figure 26). At some point in the future, cheques will become economically unviable. The future of cheques must be carefully managed.

**Figure 26: Australian cheque usage**



Source: RBA, ABS.

Note: Fiscal years from 1 July to 30 June.

The high per-unit cost for cheques is due to transporting physical copies of cheques to a central location to exchange with the cheque writer's bank, as well as storage of cheque images for seven years, issuing cheque books and fraud prevention.

Price signals for users initiating cheque payments are unfortunately weak. The costs of cheque payments are not reflected in their transaction pricing to payers. Much of the cost of a cheque payment is borne by the financial institutions involved in processing the payment. This cost is largely cross-subsidised by other banking products, rather than being charged to cheque users.

The RBA has expressed a similar view on cheques:

*"Part of the reason that cheque use remains relatively widespread is that cheques are inexpensive to those writing them, with most of the costs borne by the payees and the financial institutions that process them. This model is likely to become harder to sustain as unit costs continue to increase."*<sup>83</sup>

Segments of the population are sensitive to any changes to the convenience or pricing of cheques. Submissions<sup>84</sup> received by APCA in response to its consultation on 'The Role of Cheques in an Evolving Payments System' are evidence of these sensitivities. As such, an ADI must internalise the large implicit cost subsidy available to users of cheques, because cost-based pricing would likely result in damage to its brand and imposition of cost on customers least able to pay.

<sup>82</sup> Total payment cost (including consumer costs) for non-point of sale cheque payments. RBA, 'Payment Costs in Australia – A study of the Payment methods', November 2007.

<sup>83</sup> RBA, 'Website on Strategic Review of Innovation in the Payments System: Issues for Consultation', June 2011, (<http://www.rba.gov.au/publications/consultations/201106-strategic-review-innovation/issues/decline-traditional-payment-methods.html>).

<sup>84</sup> APCA, 'The Role of Cheques in an Evolving Payments System', Consultation website (<http://www.apca.com.au/consultation/submissions.html>).

The RBA's direct charging standards have addressed cross-subsidisation of other payment types by making price signals more effective.

- For card payments, merchants are permitted to add a charge on to the cost of a transaction to recover the cost of card payment.
- For ATM usage, a direct charge applies to users who do not belong to the same ATM network. The fee is disclosed upfront and is paid directly to the ATM provider.

Commonwealth Bank believes if cheque payers were confronted with a transparent and upfront charge for making a payment, many would re-evaluate their payment choices. Providing merchants with the option to surcharge for acceptance of cheque payments would ensure the customer's choice of payment instrument considers the relative cost of each instrument, resulting in a more efficient usage of the payments system. This is in keeping with the objectives of the RBA's card market reforms.

## 4.2 Potential solutions

The RBA acknowledges the benefits associated with a direct charge for cheque usage, as well as the difficulty of implementing such a regime as a result of public displeasure:

*"One possible response by market participants would be a change in pricing structure, with financial institutions and large recipients of cheques passing their costs on to the payers in a transparent way. Of course the decision to do so would be unpopular with some segments of the community and might be difficult for institutions to make unilaterally. Equally, competition law concerns might make collective action difficult."*<sup>85</sup>

### Impose interchange fees on cheque payments

Commonwealth Bank **recommends** the PSB sets a multilateral interchange fee on cheque payments, payable by the payee's ADI to the payer's ADI. This would compensate the payer ADI for the costs associated with cheque issuance and processing. The payee ADI would have an incentive to pass this fee on to its customer, the recipient of the cheque payment. The recipient in turn would have an incentive to surcharge for cheque payments and/or actively discourage cheque payments.

This should be complemented by an education campaign to inform organisations that they are allowed to charge a pre-disclosed cost-based fee to recover their cost of accepting a cheque payment. A sunset date of, for instance, 2020 could be applied to the interchange fee in an effort to drive down cheque usage between now and then.

### Governments to lead by example

Commonwealth Bank **recommends** all governments lead by example by introducing a policy to mandate usage of electronic payments within its sphere of operations and phase out paying by cheque.

Commonwealth Bank also **recommends** that all governments promote electronic payments to its customers by either phasing out acceptance of, or imposing a surcharge on, cheque payments.

### Education

Commonwealth Bank **recommends** the Government help to educate Australian businesses about the efficiencies of electronic payments over paper-based payments.

Commonwealth Bank **recommends** the PSB should consider and report on the future of cheques in Australia to increase awareness of issues related to cheque usage and the need to phase out cheques eventually.

85 RBA, 'Submission to APCA's Consultation Paper, 'the Role of Cheques in an Evolving Payment System'', 29 July 2011.

### 4.3 Support for the transition

The industry is mindful of customers who still rely on cheques to make payments, and will support these customers until cheques are eventually defunct. Commonwealth Bank acknowledges its obligations to support the needs of its elderly and regional customers in particular.

The following recent industry initiatives have improved the functionality of electronic payment methods, with further improvements to come, thereby easing the transition away from cheques:

- Same day settlement of direct entry transactions has improved the convenience offering of direct entry payments vis-à-vis cheques.
- E-conveyancing replaces cheque payment with electronic payment for property settlements.
- The NPP, once operational, will increase options for electronic payments.

Commonwealth Bank also helps its clients optimise their mix of payment usage and acceptance by:

- Making customers aware of the broad range of innovative payment options which may better suit their needs.
- Assisting customers who wish to increase their usage of electronic payments.
- Increasing the incentives for making and receiving electronic payments.

See Appendix III also for detail on the transition from cash to electronic payments. Australians are beginning to embrace electronic payments as a replacement for cash payments. This trend is to be both expected and encouraged – electronic payments are far more convenient and efficient than paper-based payments.



A photograph of a middle-aged man with grey hair and a mustache, smiling broadly. He is wearing a grey and white striped t-shirt. He is standing outdoors next to a white vehicle, possibly a truck or a boat, with a blue sky in the background. The text is overlaid on the bottom left of the image.

**THE FINANCIAL  
SYSTEM SHOULD  
MAKE SAVERS FEEL  
CONFIDENT, SECURE  
AND ENGAGED IN  
MANAGING THEIR  
SUPERANNUATION.  
COMMBANK CAN.**

# SECTION IV: SAFEGUARDING AUSTRALIA'S RETIREMENT WITH A SUSTAINABLE SUPERANNUATION SYSTEM

## CHAPTER 10: IMPROVE THE EFFICIENCY OF THE SUPERANNUATION SYSTEM

### SUMMARY

- Superannuation is forecast to grow to over \$6 trillion in 20 years.<sup>86</sup> It will approach the scale of the banking system.
- The strength and efficiency of superannuation is important to protect the interests of individuals saving for a self-funded retirement, remove unnecessary costs built into the system which can reduce individuals' retirement savings, and protect the stability of the financial system as a whole.
- Regulation plays an important role in supporting these objectives.
- Commonwealth Bank has identified superannuation regulatory issues to be reviewed by the Inquiry:
  - The growing overlap between regulators, especially APRA and the Australian Securities and Investments Commission (ASIC). The blurring of lines between prudential regulation and consumer protection has led to inefficiencies, particularly around capital, disclosure, reporting and prudential requirements.
  - The need for consistency of regulation across all superannuation funds, in light of the size and growth rate of the Self-Managed Superannuation Fund (SMSF) sector.
  - The ongoing inefficiencies associated with maintaining legacy products, which impact superannuation, life insurance and managed investment schemes.
  - Fragmented and inconsistent domestic and international capital reforms. This creates regulatory arbitrage opportunities and conflicting capital requirements, which may undermine confidence in the industry and the retirement savings system more generally.
  - The duplicative and inefficient process for selecting default superannuation funds under modern awards,<sup>87</sup> in addition to the existing MySuper authorisation requirement under APRA.

<sup>86</sup> Rice Warner, 'Superannuation Market Projections', 2012.

<sup>87</sup> Modern awards are legal documents that set minimum employment entitlements for specific industries or occupations. Most industries are subject to a modern award. They apply on top of the National Employment Standards.



## RECOMMENDATIONS

### Recommendations for improving regulation efficiency

- Review and clarify the responsibilities of superannuation regulators. Eliminate overlap between APRA and ASIC and improve knowledge sharing and coordination between these two organisations.
- Commit to developing a robust product rationalisation process for superannuation funds, life insurance products and managed investment schemes.

### Recommendations for ensuring competitive neutrality

- Develop a holistic approach to capital regulation whereby duplication is eliminated and like activities attract the same requirements.
- Amend legislation to allow an employer to select any MySuper product as the default superannuation fund for their award employees.

## 1. CONTEXT

Superannuation was in its infancy when the Wallis Inquiry reported in 1997. It is now a well established, significant and growing part of the financial system. Compulsory superannuation, known as the Superannuation Guarantee Contribution (SGC), has now been in place for 22 years. During this time, superannuation has grown from a system serving part of the nation (before the SGC, superannuation coverage was only 51% in 1988) to being near universal for all working Australians (90% now have coverage in some form). It has increased from \$0.2 trillion in assets in 1994<sup>88</sup> to \$1.6 trillion in 2013,<sup>89</sup> and is the fourth-largest retirement savings system in the world.<sup>90</sup> The system is forecast to grow to \$6 trillion in assets by 2030,<sup>91</sup> a scale comparable to the banking system.

Superannuation improves an individual's financial outcomes by encouraging people to save for the future (by foregoing current consumption) and ultimately helps them to self-fund their retirement.

Superannuation improves macroeconomic outcomes by driving economic growth through its impact on national savings and investment. Empirical evidence indicates that the superannuation guarantee may have increased the household saving rate by up to 1.5-2.0% of GDP.<sup>92</sup> This provides liquidity to domestic financial markets, funds investment and relieves pressure on the social welfare budget.

Age Pension-related payments are projected to increase from 2.7% of GDP in 2009-2010 to 3.8% by 2049-2050.<sup>93</sup> While the cost to GDP is substantial, it is relatively low compared with most other OECD countries as a result of the application of means testing in the Australian system. Importantly, by 2049-2050, the proportion of pensioners receiving full Age Pension will reduce and the proportion receiving part Age Pension will increase. This is evidence that individuals are increasingly self-funding their retirement through superannuation savings. This is also important given the material rise in expenditure relating to other costs of living post-retirement such as health care, which are due to rise from 4.0% to 7.1% of GDP by 2049-2050.<sup>94</sup>

88 Nielson, L., 'Chronology of Superannuation and Retirement Income in Australia', Parliament of Australia, 1 June 2010, p. 5.

89 APRA, 'APRA releases quarterly superannuation statistics for September 2013', Media Release, 21 November 2013.

90 Towers Watson, 'Global Pension Assets Study', 5 February 2014.

91 Rice Warner, 'Superannuation Market Projections', 2012.

92 The Allen Consulting Group, 'Better Living Standards and a Stronger Economy: the Role of Superannuation in Australia', September 2009.

93 'The Intergenerational Report', 2010.

94 These include the Australian Transaction Reports and Analysis Centre (AUSTRAC), the Office of the Australian Information Commissioner (OAIC), the ACCC and the Australian Crime Commission (ACC).

The financial system should make savers feel confident, secure and engaged in managing their superannuation. In order to effectively support savers in self-funding their retirement, the stability of the superannuation system must be protected. The superannuation system should be free of unnecessary complexity and cost. Inefficient regulation and change impose costs on the system and are partly borne by members, impacting the value of the balances available to fund their retirement.

The system has undergone significant regulatory change as it has grown. This Inquiry presents an opportunity to ensure that the settings for the superannuation system are sustainable for the next stage of growth.

## 2. IMPROVING REGULATION EFFICIENCY

### 2.1 Minimising overlap between regulators

The superannuation industry is highly regulated. There are currently three primary regulators of superannuation. ASIC and APRA are the two main regulators for large superannuation funds. The ATO also regulates some of the activities of larger superannuation funds and is the primary regulator of SMSFs.

There are a number of other regulators currently relevant to financial services and wealth management,<sup>95</sup> as well as a range of external dispute resolution systems and other relevant bodies which often have quasi-regulatory status given the impact of the decisions they make.<sup>96</sup>

Commonwealth Bank supports the twin peaks model but has observed growing overlap and inconsistency between regulators in the superannuation context, in particular when considering the functions of ASIC and APRA.

This has become more pronounced with the implementation of the Stronger Super reforms. In particular, the new MySuper and APRA requirements, including disclosure, reporting and prudential, have proved problematic for financial services providers. As a result, the responsibilities of the two regulators have begun to overlap, blurring the lines between prudential regulation and consumer protection.

There are now a number of instances where APRA and ASIC appear to offer different views on the same matter, or attempt to regulate the same issue. This has no apparent benefit for savers and creates duplication, inefficiency, distortion, uncertainty and lack of transparency.

The following examples illustrate the point:

- **Dual regulated entities.** It is common in the retail sector of the financial services industry to be both a Registrable Superannuation Entity (RSE) licensee (licensed by APRA) and also a Responsible Entity (RE) (licensed by ASIC). As part of the Stronger Super reforms, dual regulated superannuation funds will no longer be exempt from the Corporations Act's resources and risk management requirements for REs, supervised by ASIC. Commonwealth Bank is concerned that removal of this exemption will duplicate ASIC's and APRA's capital requirements.
- **Disclosure and fees.** In 2001, the superannuation disclosure obligations were transferred from the Superannuation Industry (Supervision) Act 1993 (SIS) (regulated by APRA) into the Corporations Act 2001 (regulated by ASIC) as part of Financial Services Reform (FSR). With the introduction of the Stronger Super reforms and Prudential Standards, numerous additional disclosure requirements (such as conflicts registers, executive remuneration and systemic transparency requirements) have now been included within SIS, duplicating ASIC's requirements.

<sup>95</sup> These include the Australian Transaction Reports and Analysis Centre (AUSTRAC), the Office of the Australian Information Commissioner (OAIC), the ACCC and the Australian Crime Commission (ACC).

<sup>96</sup> These include the Financial Ombudsman Service (FOS), the Superannuation Complaints Tribunal (SCT) and the FWC.



- **Product Dashboard and the Portfolio Holdings Disclosure and Reporting Requirements.**

As a result of legislative changes through the Stronger Super reforms, trustees are required under the Corporations Act (enforced by ASIC) to produce product dashboard disclosures and disclose significant quantities of information to superannuation members. Similar disclosure requirements are set out in the Financial Sector (Collection of Data) Act 2001 (enforced by APRA), including the type and value of assets that funds invest in on a full look-through basis. This duplicates and complicates disclosure requirements and may not assist investors in understanding the nature of their investment within their superannuation funds.

Commonwealth Bank acknowledges that these requirements are likely to be the subject of further consultation and inquiry. However, if a twin peaks model is maintained, there are opportunities to streamline the reporting processes between the regulators.

There are two commonly discussed options for improving regulation of superannuation and removing overlap and inconsistencies between regulators. One option is to establish a single regulator of superannuation. The other option is better co-ordination and clarification of the roles of the existing regulators. Commonwealth Bank supports the latter option given the overall success of the current structure.

Commonwealth Bank **recommends** a review of both ASIC's and APRA's roles in relation to superannuation. The review should assess whether their functions remain consistent with the intentions of the twin peaks model. Commonwealth Bank also **recommends** that ASIC and APRA continue to improve engagement and knowledge sharing via COFR. Transparency of the output of this engagement (e.g. through the release of minutes or updates) will ensure accountability and assist the industry to understand the regulators' approach.

## 2.2 Enhancing regulatory consistency across superannuation structures

APRA is the prudential regulator for all large funds and small APRA funds (SAFs). However, it only supervises around two-thirds of superannuation assets. SMSFs are regulated by the ATO. The ATO explains its role as follows:

*"They [SMSFs] are not prudentially regulated but are subject to compliance-based regulation. This approach recognises that, because the members of an SMSF are also its trustees, they are in a position to protect their own interests ... Our focus is on compliance with super and tax laws. We undertake activities to check compliance in order to safeguard retirement savings, but we do not consider or provide specific guidance on the investment risk a strategy has, or how trustees should manage that risk."*<sup>97</sup>

At present there is a lack of regulatory consistency and treatment between fund types even though the same legislation applies uniformly across all funds.

The growing size and importance of the SMSF market suggests Government should ensure regulatory mechanisms are in place to provide appropriate supervision of the sector as a whole.

SMSFs have grown rapidly in number (now around 510,000 funds) and average asset size (now just under \$1 million per fund). SMSFs now account for 31% of total superannuation assets.<sup>98</sup> Assuming that this proportion is maintained and the superannuation system grows to over \$6 trillion by 2030 as projected,<sup>99</sup> SMSFs will manage approximately \$2 trillion of assets.

97 ATO, 'How your SMSF is Regulated – Overview for SMSF Trustees', March 2013.

98 APRA, 'Annual Superannuation Bulletin', June 2013.

99 'Superannuation Market Projections', 2012.

There are a number of developments which Commonwealth Bank believes Government and regulators should continue to monitor:

- The size and growth rate of the market.
- The potential for increased systemic risk.
- The ability of trustees to make appropriate financial decisions that suit their needs.<sup>100</sup>
- The quality of consumer outcomes and lower levels of consumer protection than apply to other sectors.
- A relative lack of risk controls.
- The ability to enter into borrowing arrangements.

In the longer term, Commonwealth Bank believes an optimal model of regulation involves applying consistent regulatory controls across all funds.

### 2.3 Rationalising legacy products

The superannuation and life insurance sectors continue to face a significant burden from an increasing number of legacy products. With some products in force for 40 years and more, the number of legacy products in these areas will continue to grow. A previous industry estimate, issued in 2009, suggested that around \$221 billion or 25% of all funds at that time could be considered legacy in nature.<sup>101</sup>

Products become legacy due to their nature and duration. Providers are required to guarantee the renewability of contracts long term and maintain products that are no longer being offered. Regulatory and tax changes introduce new product features and industry activities. The recent commencement of the MySuper regime, which has seen an increase in the number of highly competitive offers to superannuation customers, is likely to have increased the amount of funds that are legacy.

The burden of managing legacy books can negatively impact customers in the following ways:

- High costs due to lower number of policyholders or members to share the costs as existing policyholders lapse with no new business entering the pool.<sup>102</sup>
- Reduction in quality of service as providers switch attention to products with growth potential.
- Investment advice given in relation to legacy products may be limited as financial advisers are unfamiliar with the product.
- Lack modern service options such as internet access to account information as they run on legacy IT systems.

The administration of legacy products is also problematic for providers.

- A large number of small products are more expensive to administer than fewer rationalised products.
- Legacy systems are more prone to errors and fraud because they generally require more manual processing of data. Upgrading legacy systems may give rise to additional costs, due to the need for individual solutions to problems and lack of economies of scale.

<sup>100</sup> 81% of SMSFs found some aspect of running their SMSF to be a challenge and 30% of SMSF trustees thought it difficult keeping track of changes in rules and regulations. ASIC, '2013 Investment Trends SMSF investor report', Volume I, April 2013, pp.135.

<sup>101</sup> Commonwealth Department of Treasury, 'Product Rationalisation of Managed Investment Schemes and Life Insurance Products – Proposals Paper', December 2009.

<sup>102</sup> Lapse occurs due to natural attrition or 'select lapsation'. As policyholders lapse naturally, premium rates for a legacy product increase as no new business could enter the product pool. As premiums rise or as the product is deemed outdated, 'select lapsation' would occur. The healthier customers will seek lower premiums or better product features elsewhere and accelerate the deterioration in risk profile, further increases premium rates given the loss of ability to cross subsidise.

A number of previous reviews by the Government have examined product rationalisation.<sup>103</sup> These reviews have not yielded a solution to enable product rationalisation across life insurance, superannuation or managed investment schemes. The only reform which has occurred was the loss rollover relief for superannuation fund mergers, a temporary measure ending 30 June 2011. The industry is concerned this issue has not received the focus it requires.

Commonwealth Bank considers that product rationalisation offers a number of benefits.

- Provides access to modern product features and functions.
- Uses efficient product structures that are easier for the industry to operate, for boards and Trustees to review, and for regulators to supervise.
- Provides better protection against products that may no longer be appropriate for the current market.

In 2007, the Treasury estimated that the introduction of a product rationalisation mechanism could realise annualised cost savings of between \$120 million (conservative) to \$350 million (optimistic),<sup>104</sup> by reducing the number of products on the market and removing duplication, red-tape and inefficiency.

Commonwealth Bank **recommends** continuous development of a robust product rationalisation process for superannuation funds, life insurance products and managed investment schemes. The development of this framework should consider: the appropriate independent verification process; appropriate communication and disclosure plans for the transition of products; the relevant tax issues that need to be resolved; the reinstatement of loss transfer rules for successor transfer of superannuation monies; and the replacement of the 'equivalence' test with a no disadvantage test for successor fund transfers as described in the Super System Review.

### 3. ENSURING COMPETITIVE NEUTRALITY

#### 3.1 Context

There are two areas where Commonwealth Bank believes the principle of competitive neutrality should be enforced: a level playing field for capital requirements and the default fund selection process for employment awards.

#### 3.2 Levelling the playing field for capital requirements

There have been a number of domestic and globally-based reforms proposed to amend the capital requirements for wealth management entities.<sup>105</sup> Commonwealth Bank recognises that the intention of capital reform is to improve the stability of Australia's financial services sector and promote consumer confidence. However, the approach to date has been fragmented and inconsistent. This has resulted in conflicting capital calculation methodologies and start dates.

Commonwealth Bank is concerned that this creates opportunities for regulatory arbitrage and inadequate levels of protection for investors.

<sup>103</sup> The Productivity Commission, 'Annual Review of Regulatory Burdens on Business', 2010; 'The Super System Review', 2010; 'Regulation Taskforce – Banks Review', 2006; Treasury 'Government response to Banks', Paper, 2007.

<sup>104</sup> Commonwealth Department of Treasury, 'Product Rationalisation Issues Paper', 2007.

<sup>105</sup> For example, APRA – Conglomerate Supervision, Life and General Insurance Capital Standards, RSE requirements, ASIC – RE and Investor Directed Portfolio Services requirements and the Basel reforms.

For example, under APRA's Level 3 framework, a funds management business that is part of an Australian conglomerate group will be at a competitive disadvantage to an equivalent business held outside an Australian conglomerate which is subjected to minimal capital requirements.

There are also different regulatory standards for responsible entities (managed funds) and superannuation, and different capital requirements for custodians and platform operators.

Inconsistent capital requirements threaten to undermine confidence in the industry and have the potential to result in a concentration of risk in lower capitalised entities. They also create competitive issues in parts of the industry, which essentially provide the same broad services to customers but may be subject to vastly different capital requirements.

Commonwealth Bank **recommends** a holistic approach to capital regulation be developed whereby duplication is eliminated and like activities attract the same requirements. This would likely include consideration of reinstating the exemption for Responsible Entities (licensed by ASIC) to comply with resource (capital) and risk management requirements under the Corporations Act where they are also being regulated by APRA as part of a conglomerate (discussed in Section 2.1).

### 3.3 The selection of default funds under modern awards

Superannuation funds are now required to have an APRA-authorised MySuper product in order to receive compulsory employer contributions. However, if they hope to receive contributions from award-based employees the fund also needs to be named in a modern award. This requires the fund to apply to the FWC's Expert Panel to be included in the default superannuation fund list (first stage) and apply to the full bench of the FWC to be listed in each modern award in which they seek to be named (second stage).

It is possible that a large number of funds will seek to be named on all 122 modern awards.

The Colonial First State FirstChoice Employer Plan has many existing employer plans across multiple industries and employers. These employers require the fund to be listed in order to continue to make compulsory superannuation contributions to this fund on behalf of their employees.

Commonwealth Bank believes the process to select default superannuation funds within employment awards is unnecessary. Trustees have only recently undertaken the rigorous and costly process of achieving APRA MySuper product authorisation. For trustees to now have to apply to another body for the right to compete to provide services to a large segment of the market is duplicative and inefficient whilst imposing unnecessary cost.<sup>106</sup>

Commonwealth Bank **recommends** that legislation be amended to allow an employer to select any MySuper product as the default superannuation fund for their award employees.

---

<sup>106</sup> The initial estimate of the impact is \$400 million, based on a draft research report by Rafe Consulting, 'Impact of Changes to Fair Work Act on the Australian Superannuation Sector, Employers and their Employees'. The final report is expected to be due in the second quarter of 2014.

## CHAPTER 11: FUND AUSTRALIA'S RETIREMENT

### SUMMARY

- Superannuation has become increasingly important to support households' savings and to encourage self-funded retirement.
- The current level of superannuation contribution is unlikely to be sufficient to support every Australian's lifestyle expectations for retirement.
- Access to quality and affordable financial advice is a key enabler of ensuring adequacy of retirement income.
- To ensure the potential public costs associated with increasing longevity risk are managed appropriately there is a need to focus on encouraging the take-up of income streams rather than lump sum benefits.

### RECOMMENDATIONS

- Encourage higher contributions into superannuation for retirement saving:
  - Explore the introduction of optional contributions to increase default contribution levels.
  - Increase the annual contribution caps to their original levels or introduce a lifetime limit.
- Make financial advice tax deductible and unify tax deductions between upfront and ongoing payments for financial advice.
- Encourage the take-up of income streams in retirement (but do not support disincentives on other forms of withdrawal, e.g. tax on lump sum).
  - Remove regulatory barriers to facilitate the development of income stream products which address longevity risk.
  - Enable a seamless transfer from accumulation to pension upon member consent (but not an automatic default).
  - Introduce disclosure requirements for income stream projections on member statements.
  - Improve financial literacy, particularly for pre-retirees, on the importance of income streams in retirement.
  - Introduce longer-term Government bonds to enable product development.

## 1. CONTEXT

For the past 22 years, the superannuation system has been predominantly focused on savings accumulation and investments. As 'baby boomers' are now transitioning to retirement, the system needs to increase focus on establishing a drawdown framework and ensuring income adequacy for retirement.

This Inquiry presents an opportunity to examine the critical issues in the superannuation system to ensure the settings are sustainable for the next stage of the system's growth.

## 2. IMPROVING RETIREMENT INCOME ADEQUACY

The Association of Superannuation Funds of Australia (ASFA) Retirement Standard benchmarks the annual expenditure required for Australians to fund their retirement (Figure 27).

**Figure 27: Estimated annual expenditures during retirement**

Retirement lifestyle	Single	Couple
Modest	\$23,175	\$33,358
Comfortable	\$42,158	\$57,665

Source: ASFA Retirement Standard, December 2013.

Note: Assume that the retiree(s) own their own home and relate to expenditure by the household. A modest lifestyle covers basic activities while a comfortable lifestyle assumes purchase of household goods, private health insurance, a reasonable car, good clothes, electronic equipment, as well as domestic and occasionally international holiday travel.

The required expenditures of a modest lifestyle can be largely met by the Age Pension of \$21,563 for a single person and \$32,505 for a couple.<sup>107</sup> The lump sum amounts required to fund different retirement lifestyles for different households are summarised in Figure 28.

**Figure 28: Superannuation lump sum amounts required to fund retirement**

Retirement lifestyle	Single		Couple	
	No Age Pension	With Age Pension	No Age Pension	With Age Pension
Modest	\$355,000	~\$25,000 <sup>108</sup>	\$510,000	~\$15,000 <sup>108</sup>
Comfortable	\$645,000	>\$390,000 <sup>109</sup>	\$880,000	>\$440,000 <sup>109</sup>

Source: A Comfortable Retirement: How Much Super is Enough?, SuperGuide, 28 November 2013.

Notes: The lump sum amounts are in today's dollars. Assumes retirement age of 65, annual inflation rate of 3%, investment return of 7%, life expectancy of 87 and Age Pension guidance from September 2013.

<sup>107</sup> Assumes entitlement to the part/full Age Pension benefits. Based on Age Pension from September 2013, including the pension supplement payment. ASFA, 'Retirement Standard', December 2013.

<sup>108</sup> Assumes entitlement to the full Age Pension.

<sup>109</sup> Assumes entitlement to the part/full Age Pension benefits, but capped at \$645,000 for a single person and \$880,000 for a couple where no Age Pension is received.

<sup>110</sup> ASFA, 'Retirement Standard', December 2013.

Given the industry benchmarks, ASFA assessed the retirement lifestyle accessible to a single person based on various contribution rates (Figure 29).<sup>110</sup>

On a conservative basis, with a contribution rate of 9%, a single person earning \$50,000 p.a. or below over their working life could live a modest retirement lifestyle assuming entitlement to the full Age Pension benefits, while having extra savings for additional consumption. On the same basis, a single person earning \$100,000 p.a. could live a modest retirement lifestyle without any Age Pension benefit. However, both cohorts would fall short of the comfortable lifestyle benchmark, if they were to rely only on their superannuation savings.

Increasing contribution levels to 12% enables retirees to attain an improved retirement lifestyle, with more savings available for desired consumption. A single person earning \$100,000 p.a. could achieve ASFA's comfortable benchmark assuming entitlement to some Age Pension benefits.<sup>111</sup>

**Figure 29: Lump sum retirement benefits for a single person after 30 years of contribution**

Contribution level	Wage of \$30,000 p.a.	Wage of \$50,000 p.a.	Wage of \$100,000 p.a.
9% contributions	\$110,000	\$183,000	\$366,000
12% contributions	\$146,000	\$244,000	\$487,000

Source: ASFA Retirement Standard, December 2013.

Notes: All figures in today's dollars (using 3.75% AWE as a deflator), investment earning rate of 7%, contributions and investments taxed at current rates.

Research conducted by Allen Consulting in 2011 also shows that:<sup>112</sup>

- The current level of contributions is not sufficient to support Australians' lifestyle expectations for their future retirement.
- A 9% SGC rate will generate low retirement incomes by international standards, well below average OECD replacement rates.<sup>113</sup>
- Even if 9% contributions were sufficient when the SGC was introduced, increases in life expectancy imply that an increase in the rate of the SGC is required, all other variables remaining equal.

This issue is partly attributable to 'baby boomers' having only participated in compulsory superannuation for part of their working lives. There will be growing budgetary pressure due to calls on the Age Pension as a result of the ageing of the population if retirees are not able to self-fund their retirements.

Commonwealth Bank supports the increase in the SGC to 12%. Recognising that some individuals will require higher contribution levels, Commonwealth Bank **recommends** the introduction of optional contributions, sometimes referred within the superannuation industry as 'soft compulsion'. Under this system, an employer could increase an employee's superannuation contributions through mechanisms such as salary sacrifice (e.g. 0.5% or 1% on an annual basis or at other pre-determined events, capped at a certain level, e.g. 15%) with the employee having the ability to opt out each time. This ensures members who will benefit from higher contribution levels have access to a facility to exchange a portion

<sup>111</sup> High income earners will likely meet the ASFA comfortable retirement standard, but may require higher rates of contribution to meet their desired standard of living in retirement. A replacement rate, e.g. 65% of pre-retirement income may be more appropriate for the high income earners as a benchmark.

<sup>112</sup> The Allen Consulting Group, 'Enhancing Financial Stability and Economic Growth – the Contribution of Superannuation', August 2011.

<sup>113</sup> OECD, 'Pensions at a Glance', 2013. For workers with average earnings, the gross replacement rate averages 54% in the 34 OECD countries. Australia's gross replacement rate for an average income male earner is 52.3%, and 47.8% for female.



of their salaries for an increase in contributions. Some employers have already put such a facility in place. Commonwealth Bank acknowledges that the broad impacts on the economy will need to be considered in implementing this system.

Commonwealth Bank also **recommends** restoring the contribution caps for voluntary contributions to previous levels or considering the introduction of a lifetime contribution limit. This will help to maintain consumer confidence in the system.

While it is difficult to enforce a certain level of retirement lifestyle choice, Commonwealth Bank believes that higher superannuation savings can help Australians better self-fund their retirement and reduce overall reliance on the Age Pension.

### 3. IMPROVING ACCESSIBILITY TO AND AVAILABILITY OF FINANCIAL ADVICE

An effective method of increasing the likelihood of having an adequate retirement income is to provide Australians with access to quality and affordable financial advice. The Financial Services Council (FSC) and others have previously highlighted the distortion that arises from the tax treatment of fees paid for financial advice. Currently, the cost of financial advice can be tax deductible if it is paid for on an ongoing basis, including instalment payment plans. Advice fees are not deductible where the fee is paid up-front.

Commonwealth Bank **recommends** making the cost of financial advice tax deductible for consumers and unify tax treatments for different payments of financial advice. This is consistent with the objectives of making financial advice accessible and affordable for more people. Uniform tax deductibility for upfront and ongoing financial advice fees would address the current tax distortion and encourage greater retirement income savings thereby reducing reliance on the Age Pension.

### 4. ENCOURAGING HIGHER TAKE-UP OF RETIREMENT INCOME STREAMS

#### 4.1 Context

To date, retirement income adequacy discussions have generally focused on the need to achieve an adequate superannuation account balance (lump sum) at retirement.

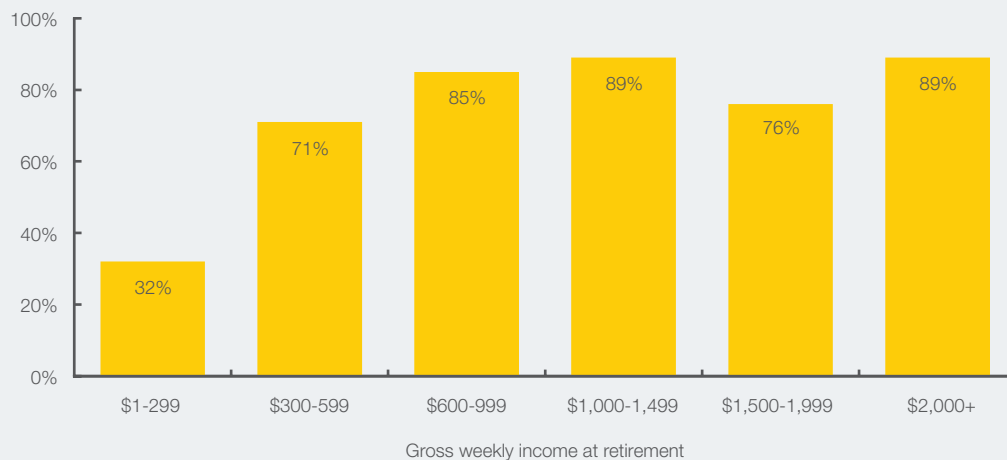
Commonwealth Bank understands there is a perception amongst some policy makers and others within the industry that a 'lump sum' culture exists in Australia. Superannuation members are said to withdraw a lump sum upon retirement then dissipate their savings quickly and rely on the Age Pension to fund their remaining retirement costs. This may be driving some parties to consider the reintroduction of taxes on lump sums in retirement.

Commonwealth Bank believes that this perception is misleading. Research has found that:<sup>114</sup>

- The proportion of retirees taking lump sums is falling over time.
- Repaying debt (housing debt) is the major use of lump sums in retirement, but in most cases this leaves significant amounts to invest to generate retirement income.
- More than 70% of people on incomes of more than \$300 per week take part of their benefit as a pension (Figure 30).
- More than 50% of the lump sum withdrawals are for less than \$50,000.

<sup>114</sup> Rothman, G. and Wang, H., Commonwealth Department of Treasury, 'Retirement Income Decisions: Take-Up and Use of Australian Lump Sum and income Streams', July 2013.

**Figure 30: Proportion of retirees taking an income stream (with or without partial lump sum)**



Source: Retirement Income Decisions, Rothman, G. and Wang, H., Commonwealth Department of Treasury, p.8, July 2013.

At least 50% of income stream drawdowns by retirees are at the minimum rate required by law with the proportion rising with age and income. This high preference for a conservative approach to the drawdown of income in retirement is consistent with Colonial First State experience of retiree behaviour in relation to its own account-based pension book (the largest in the market).

Given the need to provide certainty for individuals and businesses in superannuation and retirement incomes policy, Commonwealth Bank does not support the introduction of taxes on lump sum benefits. Imposing taxes on lump sums is likely to impact a member's propensity to make voluntary superannuation contributions in the future and it would also impact consumers' trust in the system overall.

Instead, Commonwealth Bank favours initiatives that provide an incentive for the take-up and ongoing development of income stream products. Commonwealth Bank **recommends** the following initiatives:

- Remove regulatory barriers to product development in retirement income streams.
- Enable seamless transfer from accumulation to pension.
- Introduce disclosure requirements for income stream projections on member statements.
- Improve education to pre-retirees on income streams.
- Issue long term bonds to enable pricing and risk management.

## 4.2 Removing regulatory barriers to product development in retirement income streams

The superannuation industry has identified a number of regulatory impediments which require resolution to facilitate development of income stream products. These changes will allow products such as deferred annuities<sup>115</sup> to be developed by the market.

Commonwealth Bank supports the industry views and recommendations. A summary of these impediments and **recommendations** are outlined in Figure 31.

<sup>115</sup> A deferred annuity is an income stream which is purchased at one date (e.g. when the individual turns 65) and provides an income stream (usually lifelong) at a later date at the end of a 'deferral period'.

**Figure 31: Impediments and potential solutions for developing income stream products**

Impediment	Potential solutions
<ul style="list-style-type: none"> <li>Deferred annuities are ineligible for tax exemptions available on pension products for persons over 60 years old.</li> <li>Deferred annuities are not recognised in the SIS Act.</li> <li>Tax legislation does not accommodate deferred annuities.</li> </ul>	<ul style="list-style-type: none"> <li>Set out qualifying characteristics for longevity products in legislation rather than mirroring the characteristics of existing products.</li> <li>Provide equivalent tax treatment of post retirement products (including deferred annuities) offered by life insurance companies and superannuation funds.</li> <li>Investment earnings supporting deferred annuities and other longevity products within a superannuation fund or life insurer to be made tax exempt, including within the deferral period.</li> </ul>
<ul style="list-style-type: none"> <li>Deferred annuities do not fit into the structure of the APRA prudential standard on minimum surrender values<sup>116</sup> of pension and annuity products, making their pricing in the market less attractive to consumers.<sup>117</sup></li> </ul>	<ul style="list-style-type: none"> <li>Amend the APRA prudential standard applying to minimum surrender values of pension and annuity products to reflect the special characteristics of deferred annuities.</li> </ul>
<ul style="list-style-type: none"> <li>Deferred annuities are assessed against the means test in the deferral period even though income payments have not yet commenced, reducing retiree's eligibility for social security benefits.</li> </ul>	<ul style="list-style-type: none"> <li>Consider exempting non-commutable deferred annuities from the assets test during the deferral period, or ration the assets test exemption to say a value of \$50,000 or \$100,000.</li> <li>Apply a similar exemption to account-based pensions where access to capital is also restricted to equalise treatments between account-based pensions and deferred annuities.</li> </ul>

### 4.3 Enabling seamless transfer from accumulation to pension

A potential approach to address concerns around members dissipating their capital too quickly is to put them into an income stream by default at retirement. This has been raised as a possible future reform by industry bodies such as ASFA and the Institute of Actuaries of Australia (IAA). Broadly, the proposal is for the trustee to automatically commence an account-based pension on behalf of the member once the trustee is satisfied the member is no longer working and has reached a certain age (e.g. 65).

<sup>116</sup> The minimum value a life company must pay to an investor in certain circumstances.

<sup>117</sup> Under the current prudential standard, pricing will be unattractive given the likelihood that individuals may invoke the minimum surrender provisions if they become aware they are not likely to reach the age at which the deferred annuity or pension is payable.

Whilst Commonwealth Bank supports the intent of this initiative, it is impractical to automatically commence income stream payments without the member's direct consent (even where the member is given the chance to opt out). It is impossible for a trustee to implement a default model that suits all members in terms of when they want to retire, when they want to begin drawing on an income stream, and what level of income they wish to draw down.

Commonwealth Bank **recommends** a model which relies on member consent rather than an automatic default, and provides a seamless method of opting in to commence an income stream. For example, responding to an offer delivered through periodic member statements.<sup>118</sup> Disclosure and other legislative barriers to this require exploration.

#### 4.4 Introducing disclosure requirements for income stream projections on member statements

As previously stated, retirement income adequacy discussions have generally focused on the need to achieve an adequate superannuation account balance (lump sum) at retirement. Commonwealth Bank **recommends** efforts to inform members on the need for sufficient income streams in retirement.

This could be done by introducing a requirement for funds to include a projected annual retirement income stream in periodic member statements based on their projected final benefit. The superannuation industry and Government would need to agree on the relevant inputs to ensure a clear, consistent and meaningful approach is applied across the industry.

#### 4.5 Improving education to pre-retirees on income streams

The superannuation drawdown phase is complex with different withdrawal options available, e.g. lump sum withdrawals, account-based pensions and annuities, along with a wide range of product offerings for each option. The span of choices can be overwhelming and confusing for superannuation members. Moreover, many Australian pre-retirees are ill-informed of the options available for funding retirement.<sup>119</sup>

Superannuation members, the community at large and the superannuation system itself will benefit from measures which provide education about income streams and their benefits. Commonwealth Bank **recommends** specific focus on income streams in financial literacy programs provided by the Government and industry alike. Refer to Chapter 13 for more information.

#### 4.6 Encouraging the Government to issue long term bonds

For the annuity and income stream market to reach the depth it requires to provide flexible and competitively priced products for all future retirees, a deep and liquid long term bond market is required. Currently, there is a reasonable level of liquidity across short and medium term CGS and swap curves, but not for longer terms. This will require the Government to issue longer-dated securities.

Commonwealth Bank **recommends** the Government work with the market, including existing annuity and income stream providers, to issue long-term government bonds with tenors of up to 30 years. These securities will allow providers to better price products and to manage the investment risks associated with longevity risks. Refer to Chapter 4 for more information.

<sup>118</sup> This could be as easy as a member, upon receiving a specific 'call to action' as part of their statement (delivered through written or electronic form) at an appropriate time/age, ticking a box and providing their bank account details on the form.

<sup>119</sup> Susan Thorp, 'Financing future retirement needs: Patterns from the recent past', 2013. The research found that only 37% of Australian pre-retirees had heard of lifetime annuities and 48% had heard of account-based pensions.





**TO SUPPORT  
AUSTRALIA'S  
FUTURE THE  
REGULATORY  
SYSTEM SHOULD  
REMAIN EFFICIENT,  
EFFECTIVE AND  
ADAPTABLE.  
COMMBANK CAN.**

# SECTION V: ENHANCING REGULATORY EFFICIENCY

## CHAPTER 12: IMPROVE EFFICIENCY AND ADAPTABILITY OF THE REGULATORY SYSTEM

### SUMMARY

- The regulatory environment has not undergone a holistic review since the Wallis Inquiry.
- To support Australia's future the regulatory system should remain efficient, effective, and adaptable. There are three areas where changes can be made:
  - The efficiency of regulators' execution of duties. The ability for regulations to be applied with minimal burden on the financial system.
  - The effectiveness of the new regulation development process. Following and updating best practice regulation principles to ensure that new regulations are appropriately designed to best serve the constituents of the financial system.
  - The effectiveness of Australia's participation in the international regulatory community. International harmonisation of regulation coupled with effective implementation enhances the global financial system's strength and resilience. In 2014, Australia has a unique opportunity to play a leadership role as President of the G20.

### RECOMMENDATIONS

- Improving efficiency of regulator execution of duties:
  - Review and update the Treasurer's Statement of Expectations for financial sector regulators to incorporate principles and boundaries around which regulation is formed.
  - The membership of the Council of Financial Regulators (COFR) to extend to include all financial sector regulators and agencies.  
The RBA, as Chair, to establish a process for COFR to promote the efficiency of financial sector supervision and minimise overlaps in activity.

- Ensuring best practice regulation:
  - The Office of Best Practice Regulation (OBPR) to add to its principles and processes a new component that examines the problem to be addressed and why regulation is the preferred solution.
  - The OBPR to enhance its Regulatory Impact Assessment (RIA) process to include mandatory Regulatory Impact Statements (RIS) and Post-Implementation Reviews (PIR).
  - Responsible Ministers to hold regulatory bodies accountable for improving the transparency of their regulation development processes.
  - Independent auditors to review Government and regulatory body compliance with RIA requirements.
  - Regulatory frameworks be reviewed to determine whether the requirements imposed upon or asked of Boards are consistent with the fundamental obligation of a Director to guide and monitor the management of the company.
- Managing global financial regulatory reform and harmonisation:
  - Treasury to promote a moratorium on any new financial regulation whilst the sector implements newly introduced regulations.
  - Treasury to review and re-evaluate the mechanisms for implementing G20 reforms.
  - Treasury to promote the use of international forums, such as the FSB and BCBS, to harmonise jurisdictional implementation of international standards and to prevent jurisdictions from unilaterally enacting legislation with extra-territorial reach.

## 1. CONTEXT

The regulatory environment has not undergone a holistic review since the Wallis Inquiry established the 'twin peaks' model. The split of prudential regulation from conduct and disclosure regulation has worked well and Commonwealth Bank continues to support it.

A significant amount of new regulation has been introduced since the Wallis Inquiry and in particular since the GFC. The development and implementation of some of this regulation has resulted in inefficient outcomes. Commonwealth Bank also believes that the increasing burden that new regulation places upon Boards of Directors can blur the distinction between the roles of management and Directors.

These inefficiencies impose costs on the financial system, the economy and on customers. They can have tangible effects:

- A barrier to competition, as poorly conceived regulation unnecessarily adds to operating cost bases and demands greater economies of scale.
- A distraction from the most serious stability threats posed to the system.
- Stifled innovation in new products and opportunities to grow the sector.
- Higher compliance costs passed on to customers, impacting affordability.



Commonwealth Bank believes that there should be three primary areas of focus as the Inquiry considers what changes are required for the regulatory model to adequately support Australia's future. Firstly, how regulators can most efficiently execute their duties; secondly, what process should be used to implement future regulations consistently and unambiguously; and thirdly, how Australia should most effectively participate in the G20 regulatory agenda.

## 2. EFFICIENCY OF REGULATOR EXECUTION OF DUTIES

### 2.1 Issues with regulators' execution of duties

Commonwealth Bank identified issues that it has experienced with inefficient regulator conduct and regulation in Chapter 2. Issues include: regulation being unnecessarily imported or created where no domestic problem exists; regulations being unnecessarily in excess of global norms; poor or rushed consultation on new regulations; inconsistent regulation given multiple domestic regulators; conflict between domestic regulators; and international regulators exerting extra-territorial reach.

Commonwealth Bank believes that each of these issues can be traced to regulators not appropriately balancing the principles that guide efficient regulation to achieve its systemic protection role.

In addition, the design of regulators' roles has not necessarily adapted to market developments and future needs. The roles of regulators overseeing superannuation overlap due to inconsistent governing laws. There is also variance in approaches between APRA and ASIC. Further detail on specific overlap and inconsistencies is outlined in Chapter 10.

Innovation in business models and increased global connectivity also creates issues with the regulators' ability to suitably supervise activities that have systemic stability implications. The shadow banking sector and new technology-based market entrants are examples of business models that participate in the financial system, however they are not necessarily subject to the same regulatory scrutiny and safeguards as traditional regulated institutions.

### 2.2 Government boundaries for regulators of financial system risk

The Treasurer issued Statements of Expectations (SOEs) to the Chairmen of Financial Sector Regulators in 2007 following a review of how statutory authorities were governed.<sup>120</sup> SOEs are high-level but provide clarity from the Government's perspective as to the purpose, direction and objectives of each regulator. These are similar in concept to a Board of Directors' risk appetite statement, which establishes boundaries for the acceptable types and levels of risk which an ADI may accept.

While respectful of the independence of each regulator, SOEs also broadly paint a picture of the end-state regulatory environment to which the Government aspires.

The growing maturity of expressions of risk appetite, as a key mechanism of ADI governance, has useful application to the public sector. Commonwealth Bank **recommends** that the Treasurer's SOEs should serve a similar purpose for regulators. The Treasury should review and update the SOEs to establish principles or boundaries around which regulation is formed.

As a starting guide, Commonwealth Bank **recommends** that the principles include those identified in Chapter 2.

120 'Review of the Corporate Governance of Statutory Authorities and Office Holders', June 2003.

## 2.3 Co-ordination of regulatory authorities

COFR is a forum of the main financial sector regulators that aims to facilitate cooperation between the RBA, APRA, ASIC and the Treasury. While supportive of the purpose of COFR, Commonwealth Bank is concerned that a number of other regulators or agencies are not members. For example, the Privacy Commissioner, ATO, AUSTRAC and ACCC are all currently overseeing significant regulatory changes impacting the industry and their roles interact and overlap with the main regulators.

Commonwealth Bank **recommends** that the membership of COFR extend to include all financial sector regulators and agencies. The RBA, as Chair, should establish a process for COFR to promote the efficiency of financial sector supervision and minimise overlaps in activity

In practice COFR's membership is comprised of senior management from each agency. To enhance engagement and collaborative efforts between agencies, COFR needs to be appropriately resourced and structures need to be established to facilitate inter-agency contact at all management levels.

## 3. BEST PRACTICE REGULATION

### 3.1 Issues with development and implementation of regulations

The financial system has been subject to increasingly high volumes of regulation from both Australian and offshore authorities. These reforms are often wide-ranging and can affect multiple parts of a business, including its operations across multiple jurisdictions. Recent examples include:

- Responsible Lending legislation (2010).
- Stronger Super reforms, including SuperStream (2012-2013).
- Future of Financial Advice (FOFA) (2012-2013).
- Foreign Account Tax Compliance Act (FATCA) (2010).
- FCS.
- Ongoing OTC derivative reform (multiple countries including Australia).

Some recent, significant regulatory change in the financial services industry has been characterised by: inconsistent application of best practice regulation principles and the OBPR requirements; poor or rushed consultation; inadequate RIS; and, in some cases, the lack of a Post Implementation Review. According to the latest World Economic Forum Annual Report into global competitiveness, Australia is ranked 128<sup>th</sup> on the burden of government regulation.<sup>121</sup>

These failures to observe correct practice impose cost and inefficiency burdens on the financial system that ultimately impact its ability to efficiently service the economy and customers.

Calls to reduce regulation and cut red tape are common, however the flow of new regulation across all sectors is continuous with little progress made in eliminating redundant or ineffective regulations.

---

<sup>121</sup> Countries are ranked from the best to the worst, first is best.

As an example, over the past 10 years, an increasing proportion of Boards of Directors' time is taken up with mandatory risk and compliance matters. This includes approximately 260 obligations imposed on a Board (and its Committees) of an ADI by APRA's Prudential Standards alone. Such regulations increasingly seem to be written with a view that Boards have management or near management obligations, which is at odds with what elsewhere is deemed to be better practice. A director's fundamental obligation is to take the necessary steps to 'guide and monitor' the management of their company.<sup>122</sup> An observation in the recent *Centro* case<sup>123</sup> was that Directors can control the volume of information they receive. The proposition then is that Directors have to undertake a level of scrutiny that befits supervision, rather than have detailed direct involvement in operational matters.

The emerging risk is that multiple regulatory requirements may be in conflict with the irreducible responsibility of Directors to 'guide and monitor' management. The direct involvement of Directors in operational matters may also come at the expense of, for example, strategic input and proper governance, and carry an opportunity cost for the economy and all stakeholders.

### 3.2 Comparative performance – a guide to improvement

There has been distinct variability in implementation of recent regulatory change. This has resulted in varied quality of regulatory outcomes. This contrast is well illustrated by two examples.

#### Example of well implemented regulatory change

##### Basel III - International Framework for Liquidity Risk Measurement

**New regulation:** In December 2009 the BCBS released its framework for Liquidity Risk Measurement. The implications for the Australian financial system were immediately apparent in that there were not enough liquid assets available for ADIs to satisfy the new Liquidity Coverage Ratio.

**Change process:** APRA recognised that the new BCBS liquidity principles required adaption to ensure the unique circumstances of the Australian system were accommodated. APRA, the RBA and industry worked together to design a solution to the challenges posed by the BCBS rules. APRA secured a change to the rules that provided for alternative liquidity from central banks.

**Outcome:** When the BCBS released the final text of its Liquidity principles in December 2010, APRA and the RBA were able to announce the Committed Liquidity Facility (CLF), which provided necessary liquidity for banks to satisfy the new regulation.

122 *Daniels v Anderson* (1995) 37 NSWLR 438.

123 *ASIC v Healey & Ors* (2011) FCA 717.

## Example of poorly implemented regulatory change

### FOFA

Commonwealth Bank supports the intent of the FOFA reforms.

**Issue 1 – Time frame:** The consultation period on the draft legislation in 2011 provided less than three weeks to comment on the first and second tranches of legislation. Further, where the legislation was delayed or considerably modified, a final guide to industry was released only weeks before commencement date of the new law. This left industry insufficient time to interpret the final guidance and build in business processes; ultimately, a facilitative compliance approach was required.

**Issue 2 – RISs:** In August 2011, the OBPR noted that an adequate RIS was prepared for only one aspect of the changes. It noted that RISs prepared for other elements of the reform package were inadequate, particularly due to the lack of impact quantification regarding industry costs or consumer benefits.

**Outcome:** The original FOFA reforms have now been legislated (most reforms were effective from 1 July 2013), however, the Government has proposed a number of legislative refinements to improve FOFA. The amending legislation is currently before Parliament and has been referred to the Senate Economics Legislation Committee for Inquiry (the Committee will report by 16 June 2014).

### 3.3 Improving the process for developing and implementing regulations

To reduce the potential for inappropriate new regulation Commonwealth Bank **recommends** the OBPR modify its best practice regulation principles and processes to introduce a mandatory initial stage that includes:

- Clear identification and description of the problem and the risk it represents.
- Detail of why existing regulations are an inadequate means of addressing the identified problem.
- Articulation of options for addressing the issue and why regulation (as opposed to self-regulation or co-regulation) is the preferred approach.

Commonwealth Bank supports the Government's regulatory reform agenda,<sup>124</sup> as it relates to the overhaul of the processes for new regulations and enhancing the RIA process. In particular, Commonwealth Bank endorses the following:

- **Mandatory RIS.** Ensure that all Cabinet submissions include a RIS, which will quantify the financial impacts on business, amongst others, of complying with new regulations. This will increase the likelihood of reasonable, feasible and appropriate regulatory change.
- **PIRs.** It is critical that thorough PIRs are conducted with input from all stakeholders to avoid regulatory duplication and overreach. This will also ensure that the original intent of any regulation is achieved.
- Dedicated parliamentary sitting days for the purpose of repealing unnecessary or redundant legislation and associated regulations.

124 'The Coalition's Policy to Boost Productivity and Reduce Regulation', July 2013.

Commonwealth Bank also supports the Productivity Commission's 2012 recommendations<sup>125</sup> to improve the efficacy and rigour of the RIA process in Australia. Those recommendations include transparency measures, Ministerial reporting of reasons for non-compliance with the RIA process and accountability measures.

### 3.4 Compliance burden on a Boards of Directors

Commonwealth Bank believes that some of the matters the prudential standards require Boards of Directors to 'ensure' or which the Board has 'ultimate responsibility for' go beyond the Board's primary role, which is to 'guide and monitor' the management of a company. For example, Prudential Standard CPS 220 (Risk Management) provides a number of risk management responsibilities which the Board must ensure are in place.<sup>126</sup> There is concern that some of these matters (for example, ensuring that a sound risk management culture is established and maintained throughout the institution) go beyond the Board's oversight role and are more managerial in nature.

While it is appropriate for the Board to approve and oversee an organisation's risk management framework, the actual implementation and controls should be the responsibility of management. In other words, Board Directors should ensure that management monitors for compliance with the framework rather than monitor adherence to the framework themselves.

Commonwealth Bank **recommends** that Treasury require each regulator to review their regulatory frameworks with input from independent legal counsel. The objective of the review would be to determine whether requirements imposed upon Boards are consistent with the fundamental obligation of a company director. To the extent that such obligations would be more appropriately undertaken by management, then regulations should be amended as necessary.

## 4. PRODUCTIVITY COMMISSION REVIEW

Financial system regulators are independent of Government in relation to the performance of their function and how they exercise their powers. While the responsible Minister may have the ability to give written direction on how a policy issue is to be pursued, this reserved authority is used only in rare cases, given the Government's commitment to protecting the independence of regulators.

Commonwealth Bank's intent in recommending principles for regulatory development and best practice regulation is to provide guidance on how regulatory outcomes could be enhanced in the interests of the overall financial system.

Should these proposals be adopted, it would largely be left to individual regulators to determine how to operate within the revised framework. Commonwealth Bank notes that in 2003, John Uhrig recommended the formation of an Inspector-General of Regulation.<sup>127</sup> This body was to provide independent advice for Government on the way policy is administered and provide those affected by the operations of statutory authorities with an avenue to express concern as to the quality of regulatory outcomes.

Commonwealth Bank does not advocate for the adoption of such an oversight body at this time. However, Commonwealth Bank does suggest that the Productivity Commission perform a review of financial sector regulatory performance two years after the Financial System Inquiry. The objective of such a review would be to determine if the principles and boundaries proposed for regulation, together with the enhanced best practice processes, have been effective in delivering regulatory outcomes that are consistent with the recommendations of this Inquiry. The Productivity Commission, informed by its findings on progress made, could again consider the desirability of a permanent body to oversee regulatory outcomes and make recommendations to the Minister accordingly.

<sup>125</sup> Productivity Commission, 'Regulatory Impact Analysis: Benchmarking', 2012.

<sup>126</sup> Prudential Standard, 'CPS 220 (Risk Management)', paragraph 13 (The role of the Board).

<sup>127</sup> 'Review of the Corporate Governance of Statutory Authorities and Office Holders', June 2003.

## 5. GLOBAL FINANCIAL REGULATORY REFORM AND SOLUTIONS FOR HARMONISATION

### 5.1 Issues with global financial regulatory reform

Financial reform and strengthening the financial sector has been a key priority of the G20 since the GFC. A number of reforms have been pursued through this forum, including the development of Basel III and OTC derivatives reform. New commitments include the Global Standard for automatic exchange of financial account information, due for delivery in 2015. Commonwealth Bank supports these reforms, which aim to reduce volatility and risk, and bring transparency, strength and stability to the global financial markets.

While the G20 is an effective forum to achieve international co-operation and harmonisation of regulation, the difficulties of developing multi-jurisdictional reform, coupled with the volume of reform, has made implementation highly challenging for the financial system.

The FSB's sixth progress report on the OTC derivatives market reforms (September 2013) found that a little over half of member jurisdictions expected to have requirements in force for reporting transactions by the end of 2013. There has been even less progress in jurisdictions' implementation of central clearing, trade execution and margin requirements. G20 jurisdictions will now also have to contend with developing and implementing a global standard for automatic tax information exchange by mid-2015.

The heavy global regulatory reform agenda imposes cost on the financial system, which impacts value and services delivered to the economy and customers. Appendix IV contains a case study on the OTC derivative reform, which is a recent example of this issue.

### 5.2 Moratorium on new regulation

Commonwealth Bank **recommends** that the G20 uses its meeting in 2014 to take stock of its existing program of regulatory change and give industry time to implement these reforms before any new commitments are contemplated. In addition, the G20 should review implementation and identify opportunities for improving cross border co-operation and consistency.

Commonwealth Bank **recommends** that the Treasury promotes a moratorium on any non-essential new G20 regulatory reforms until the existing regulatory agenda has been implemented. This view has also been expressed by ASIC.<sup>128</sup>

### 5.3 A review of the framework for G20 regulation

Global reforms involving multiple jurisdictions are complex to deliver. Commonwealth Bank **recommends** that the G20 consider how commitments can be implemented in a more coordinated manner.

Through its membership of the G20 and its 2014 Presidency, Australia should promote the use of international forums to harmonise legislation and regulation impinging on industries.

Commonwealth Bank **recommends** that Treasury promote the G20 developing a high-level framework for regulators and policy makers to use as guidance for cross border regulation. This framework could include principles to guide the use of relief applications and comparability assessments of regimes, supervisory cooperation, and avenues for identification and resolution of conflict of laws issues.

The framework could also provide principles for development of regulations with extra-territorial reach. Outside of international standard setting bodies, some jurisdictions, most notably the United States, legislate with extra-territorial effect. These laws appreciably add to the costs of the Australian financial system – a recent example is the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

Greater international cooperation and convergence of laws that reflect issues of global concern would alleviate the likelihood of unintended extraterritorial impacts.

<sup>128</sup> Steven Bardy, Lowy Institute for International Policy, 'G20 Monitor No. 4', July 2013. Steven Bardy, Senior Executive, International Strategy, suggesting that focus in 2014 should be on the orderly implementation of work to date including a review of the cumulative impact of the regulatory reform agenda.





**A LOW LEVEL  
OF FINANCIAL  
LITERACY  
IMPACTS THE  
ABILITY OF  
INDIVIDUALS  
TO MANAGE  
THEIR FINANCES  
EFFECTIVELY.  
COMMBANK CAN.**



# **SECTION VI:** **ADDRESSING OTHER IMPORTANT ISSUES FOR CUSTOMERS**

## **CHAPTER 13: IMPROVE FINANCIAL LITERACY**

### **SUMMARY**

- Everyone has to make important financial decisions during their lifetime. The Australian market is based on free choice for consumers, leaving these decisions to individuals.
- The nature and complexity of the decisions change as people move through different stages of their lives.
- A low level of financial literacy impacts the ability of individuals to manage their finances effectively. Uninformed choices can have significant personal implications which affect families and in aggregate can have material implications for the stability of the economy and the Government's fiscal position.
- Considerable and ongoing effort is being made to protect consumers from making sub-optimal choices due to poor financial knowledge. However, these efforts do not address the underlying ability of individuals to make informed decisions.
- Improving financial literacy standards of Australians through education would influence the behaviour of Australians with respect to their financial affairs.
- Improved financial literacy can benefit the economy through enhanced financial wellbeing of individuals, reduced pressure on government social security schemes and greater confidence in the financial system.

## RECOMMENDATIONS

Commonwealth Bank recommends the following initiatives to improve financial literacy:

- Continue the implementation of the National Financial Literacy Strategy (NFLS). Prioritise initiatives that provide the most immediate literacy uplifts for the communities most in need.
- Sponsor a communication campaign to demonstrate the importance of financial literacy, highlighting the need for informed decision-making and personal monitoring of finances.
- Educate the public about the risk-return trade-offs and tax implications across different investment options and emphasise the importance of a lifecycle investment strategy.
- Provide clear warning messages on risky behaviour to protect customers.

Commonwealth Bank recommends financial literacy programs should target specific groups of the population:

- Include school-based financial literacy education in the national curriculum. Commonwealth Bank would be the best placed private sector partner given current involvement in various school-based financial literacy programs.
- Develop financial literacy programs for SMSF trustees to ensure they are equipped to meet trustee obligations and can assess the economic viability of a SMSF structure for them.
- Educate pre-retirees on post-retirement options.
- Harmonise powers of attorney and guardianship laws across the Federal and State Governments to ensure proper delegation of financial decisions for the elderly and to prevent 'elder abuse'.
- Develop a comprehensive program to assist small business owners develop the necessary financial skills to support their businesses.
- Sponsor financial counselling programs to assist those who are financially vulnerable to improve their financial health.

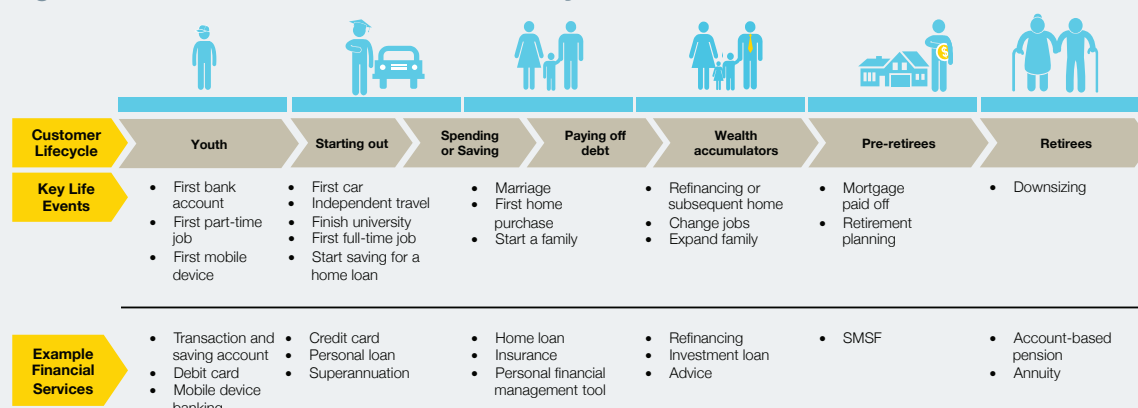
Commonwealth Bank recommends the use of new channels or approaches in delivering financial education:

- Employers and unions to help facilitate delivery of financial education programs at workplaces to foster information sharing and encourage peer support in making financial decisions.
- Deliver financial education through mobile devices, utilising opportunities from increasing penetration and uptake of mobile banking.

## 1. CONTEXT

Financial decisions are among the most important decisions individuals make in their lifetimes. The nature and complexity of these decisions change as individuals move through different stages of their lives. Examples include purchasing a home, budgeting for ongoing financial needs, insuring against adverse events and saving for a self-funded retirement. The different life stages and related financial services that individuals may evaluate are illustrated in Figure 32.<sup>129</sup>

129 For illustration only. The figure may not be representative of the circumstances of every individual.

**Figure 32: Illustration of a customer's lifecycle**

Source: Commonwealth Bank.

These decisions involve complex financial concepts such as fixed versus variable rates, risk and return profiles of different investment products, probability of adverse events happening, and longevity and sequencing risks associated with retirement.

The prevailing financial philosophy in Australia is that people should have a high degree of freedom to make their own financial choices. For example, while contributions to superannuation funds are mandatory, individuals retain the ability to choose how superannuation assets are invested. Choice is a cornerstone of Australia's defined contribution superannuation model.

Despite the important financial consequences, ASIC has found that financial decisions are frequently made with incorrect information and assumptions. In addition, there may be a gap between individuals' perceptions of their own knowledge and their actual knowledge.<sup>130</sup>

ASIC identified seven common barriers to making good financial decisions.<sup>125</sup>

- People are 'normal', not 'rational'.
- Information and choice overload.
- Complexity and uncertainty.
- Time factors and pressures.
- Over (and under) confidence.
- Self-control.
- Framing (how information is presented).

A low level of financial literacy impacts the ability of individuals to manage their finances effectively. The uninformed choices of individuals can have significant personal implications which affect families and in aggregate can have material implications for the stability of the economy and the Government's fiscal position. These include the following:<sup>131</sup>

- Inadequate savings to self-fund reasonable retirement income streams.
- Problems in paying regular expenses and increasing risk of bankruptcy.
- Magnified exposure to the effects of financial crises and emergencies due to poor savings and inadequate insurance cover.

<sup>130</sup> ASIC, 'Financial literacy and behaviour change', Report 230, March 2011.

<sup>131</sup> Some implications noted in Commonwealth Bank Foundation, 'Building Young Australians' Financial Literacy Skills, 2013, impact on social issues is a new addition.

- Undesirable social implications such as intergenerational poverty, negative impact on physical and emotional health and family disharmony.
- Demands placed on government financial support mechanisms.

Commonwealth Bank believes enhanced financial literacy could improve people's financial health, promote trust and overall confidence between consumers and the financial services industry, reduce strain on government social welfare programs, and support a stronger economy.

## 2. FINANCIAL LITERACY IN AUSTRALIA

A 2007 Government survey<sup>132</sup> found that only 34% of respondents would consider both risk and return when making investment decisions. Risks associated with current household and superannuation asset allocation (e.g. sequencing risk, longevity risk) both during the accumulation and draw down phases are not widely understood.

Further, Commonwealth Bank Foundation research (2010) found that the least financially literate are also the most vulnerable members of society. They tend to be Indigenous communities, youths, unemployed workers, students, low income earners, poorly educated workers, and non-English speakers.<sup>133</sup>

The low level of financial literacy is further compounded by functional illiteracy,<sup>134</sup> which is an emerging challenge in Australia.<sup>135</sup> This limits the ability of people who have issues with basic comprehension to be financially literate.

Current financial services disclosure requirements have led to more complexity rather than less, making it difficult for consumers with poor financial literacy to fully comprehend the product or service in question. Delivery methods have also not kept pace with technology. There have been attempts made to deliver shorter disclosure,<sup>136</sup> however in some instances this has occurred in a piecemeal fashion, applying only to certain products.

The industry recognises the potential impact of poor financial decisions and has taken various measures to address the issue. The development of MySuper and the choice architecture underlying the Stronger Super reforms are some of the measures taken to protect consumers who are unwilling or unable to perform the research required to make an informed choice.

While efforts have gone into protecting consumers from making sub-optimal choices due to a lack of financial knowledge, many policies do not address the underlying need for informed decisions. Adequately educated consumers should be able to review the full range of options and make a choice that best suits their preference and delivers optimal outcomes without any intervention.

132 Australian Securitisation Forum and Deloitte Access Economics, 'Domestic Fixed Income Assets in Australia', 2012.

133 Commonwealth Bank Foundation, 'Improving Financial Literacy: Benefits for all Australians', 2010. Indigenous communities added.

134 Basic literacy and numeracy are essential for making informed decisions. An individual needs to be able to read, write and add up to then apply those skills in financial contexts and enjoy a basic level of financial literacy.

135 ABS, 'The 2006 Adult Literacy and Life Skills Survey of Australians', January 2008 found that 46% of 15-74-year olds, or some seven million people, would struggle to understand documentation such as job applications, maps and payroll forms. 53% of surveyed Australians reached just the second of five levels in a practical numeracy test, while 70% (about 10.6 million people) managed only to progress to level two in a series of problem-solving exercises. Level three is regarded by the survey developers as the minimum required for individuals to meet the complex demands of everyday life and work in the emerging knowledge-based economy.

136 For example through Key Fact Sheets for select banking products, for superannuation Product Disclosure Statements and through incorporation by reference.

### 3. IMPROVING FINANCIAL LITERACY

**Improving financial literacy is one important component of encouraging people to make informed decisions about their finances.**

Commonwealth Bank believes that consumers should be given free choices informed by education, rather than relying on issue-specific interventions, which could potentially bring about sub-optimal outcomes.

Commonwealth Bank **recommends** the following initiatives to improve financial literacy:

- Continue the implementation of the 2011 NFLS. This includes measuring financial literacy levels and the effectiveness of programs. Prioritise initiatives that would provide the most immediate uplift in literacy for the communities most in need.
- Sponsor a communication campaign to demonstrate the importance of financial literacy, highlighting the need for informed decision-making and personal monitoring of finances. A lifecycle approach for financial education should be adopted to focus on ‘teachable moments’. These are the points when a person is about to make a specific financial decision, e.g. buying a house, insuring dependents, transitioning from superannuation funds into SMSFs, taking up health insurance and reaching the Preservation Age with access to superannuation funds.
- Provide clear messages around risk-return trade-offs and tax implications for different investment options (e.g. equity, fixed income). Retail investors should understand that high yields are a return for taking high risk and that equity returns (capital appreciation and discretionary dividends) are subject to the risks of the underlying business. People should be informed to formulate their risk appetite and make investment decisions. The concept of a lifecycle investment approach to protect sequencing risk should be understood.
- Provide clear warning messages on risky behaviour to protect customers. There should be specific focus on educating the public about ‘get rich schemes’ and highlighting the risk of transacting using unregulated digital currencies.

Commonwealth Bank **recommends** financial literacy programs should target specific groups of the population:

- **Students:** Develop and include school-based financial literacy education in the national curriculum. Money management skills should be taught to all students and applied in practical situations. This program should also extend to the Vocational Education and Training (VET) programs and university sectors per the recommendations of the NFLS. Commonwealth Bank would be the best placed private sector partner given current involvement in school-based financial literacy education as detailed in Section 4 below.
- **SMSF trustees:** Develop financial literacy programs for SMSF trustees to ensure they are equipped with the appropriate tools to manage the trustee obligations and risks that attach to their fund. Potential SMSF trustees should also be able to assess the administrative and financial requirements that come with SMSFs and the economic viability of entering into a SMSF structure.
- **Pre-retirees:** Offer programs to help pre-retirees prepare for drawing down their superannuation savings. Pre-retirees should be aware of the different drawdown options available to them, including lump sum withdrawals, account-based pensions, and annuities. They should understand the pros and cons as well as tax implications of each option in order to make informed decision. The concept of longevity protection should be understood by pre-retirees, and the importance of (lifetime) income streams, e.g. annuities should be emphasised.
- **The elderly:** Harmonise powers of attorney and guardianship laws across the Federal and State governments to ensure proper delegation of financial decisions for the elderly. A whole-of-industry working group should be established to examine the specific needs of elderly (and vulnerable) consumers, with the aim of ensuring standard practice and eliminating ‘elder abuse’.

- **Small business owners:** Develop a comprehensive program to assist small business owners develop the necessary financial skills to support their businesses. The program should contain relevant information tailored to small businesses of different nature, industry, scale and maturity. It should be made available via key distribution channels across the financial services industry, relevant departments of governments, industry associations and membership bodies.
- **Financially vulnerable groups:** Sponsor financial counselling programs to assist those who are financially vulnerable to improve their financial health. These programs should provide in-language assistance to linguistically diverse consumers and be geographically dispersed to ensure full community coverage.

Commonwealth Bank **recommends** the use of new channels or approaches in delivering financial education:

- Employers and unions to help facilitate delivery of financial education programs at workplaces, foster information sharing and encourage peer support when making major financial decisions.
- Deliver financial education through mobile devices, utilising opportunities from increasing penetration and uptake of mobile banking. New technologies and educational modes (e.g. 'gamification') should be specifically sought to improve access to, and involvement by, the more technically sophisticated community segments, especially younger generations.

#### 4. COMMONWEALTH BANK'S CONTRIBUTIONS TO IMPROVING FINANCIAL LITERACY IN AUSTRALIA

##### **Commonwealth Bank has been a champion for promoting financial literacy among**

**Australians.** In 2009, Commonwealth Bank committed to improve the financial literacy of one million children by 2015. Since then, the Commonwealth Bank Foundation's StartSmart program has booked 754,242 students to attend a primary or secondary school session. The StartSmart program is the largest face-to-face financial literacy program of its kind in the world.

Since the Foundation's StartSmart Pathways Money Management program launched in February 2012 for TAFE students, 3,819 sessions have been delivered across Australia.

The Commonwealth Bank's School Banking Program aims to develop healthy saving skills by giving students a hands-on banking experience in an interactive environment at school. In financial year 2013, the School Banking Program reached over 233,200 students through 3,520 participating primary schools across Australia.

Beyond offering school education, Commonwealth Bank's Customer Assist program also provides individual tailored solutions to help customers experiencing financial difficulty return to financial stability. This support will mean that many can avoid a poor credit rating or loss of a home. Thousands of customers benefit from this service each year with over 10,000 customers being under the care of the team at any one time. The team also works on a broad range of activities with the not-for-profit sector such as Financial Counselling Australia, including providing staff to train new counsellors who are undertaking their diploma, sponsoring their conferences and education programs and working with individual counsellors to find solutions for the most vulnerable customers.

Commonwealth Bank is also adopting a more customer-centric approach in financial education by tailoring messages based on ways that appeal to customers, e.g. gamification. Examples include Coinland for children to learn about the benefits of earning, saving and investing money by undertaking a series of tasks in the virtual world, designed to help them develop strong financial literacy skills.

## CHAPTER 14: FUND INFRASTRUCTURE DEVELOPMENT

### SUMMARY

- Infrastructure development is a key driver of Australia's economic growth and efficiency. A significant amount of investment is required to upgrade existing and build new infrastructure assets.
- Historically, governments financed infrastructure investments directly, but fiscal pressure has limited their capacity to do so more recently.
- Commonwealth Bank advocates that governments:
  - Prioritise their financial capacity for infrastructure investment into new assets.
  - Provide support to greenfield projects and insure early demand risks.
  - Create clear and defined user-pays regimes.
- Australia needs to access private infrastructure capital from four main sources: superannuation investments, private investments, bank lending and the capital markets.
- To compete for private sector funding, Australia needs to structure policies to reduce friction and improve attractiveness for investment in infrastructure.
- Commonwealth Bank welcomes initiatives that make private sector infrastructure investments more attractive and accessible:
  - Market to shift to listed debt issuance and centralised clearing. Government to simplify documentation requirements.
  - APRA to ensure that Australian banks are not subjected to excessively stringent capital regimes on infrastructure bank debt compared to their global peers.
  - Industry to support more credit enhancement structures, e.g. letters of credit offered by banks and subordinated debt offered by companies.
  - Australia to grow its fixed income and securitisation markets more broadly.

### 1. CONTEXT

Australia's capacity to fund infrastructure development is a major focus for governments and the private sector as infrastructure development is a key facilitator of economic growth and efficiency. Stimulatory infrastructure projects are key policy tools to achieve economic or social policy goals. The Australian Government has stated its intention to boost infrastructure spending to offset a post-mining capital expenditure slowdown. In 2012, major infrastructure industries contributed 10% of GDP and 7.5% of employment.<sup>137</sup> There are already signs that Australia's infrastructure is under pressure and may not adequately sustain future demand. For example, congestion remains a problem in major cities, access to ports is constrained in various locations and water quality in some regional towns fails to meet relevant standards.

The estimate of unfunded infrastructure projects based on the economic infrastructure submissions received by Infrastructure Australia currently stands at over \$80 billion.<sup>138</sup> Australia will face an economic imperative to increase infrastructure funding over the coming decade and beyond.

<sup>137</sup> 'Department of Infrastructure and Regional Development Yearbook', 2013. Australian major infrastructure industries are comprised of transport and storage, energy, communication and water.

<sup>138</sup> Infrastructure Australia, 'Submission to the Productivity Commission Inquiry into Public Infrastructure', December 2013.



## 2. GOVERNMENT FUNDING FOR INFRASTRUCTURE

Historically, Australian governments financed infrastructure investments from taxation revenue and borrowings. In recent years, funding constraints at all levels of government have increasingly limited its capacity to continually finance long-term infrastructure investments.

Governments have started recycling capital by selling existing assets to fund new projects. Viable private funding exists for brownfield assets with observable user volume and price demand and can generate attractive returns to governments while delivering optimal operating efficiencies. However, the private sector is reluctant to participate in greenfield projects with uncertain demand, price-setting and political stability. Recent greenfield road infrastructure failures have impacted private investors' appetite.

In contrast, governments are the natural owners of the early stage risks for new projects. Increasingly, availability model PPPs are being utilised to fund social infrastructure where user-pays structures are limited or politically unacceptable as well as greenfield full user-pays projects with governments retaining the early demand risks. There are various ways to structure governments' retention of these risks: by retaining the user-pays tolling for subsequent sale, or by underwriting the risk taken by private capital in earlier acceptance of the demand risks. Clear and observable sunset provisions in the latter cases are desirable.

Other potential government initiatives for infrastructure such as tax incentives or indirect special purpose funding agencies should be cautiously evaluated. These schemes can have adverse impacts on sustainable risk assessment or capital pricing and can create volatility in capital availability as schemes are amended over time.

Commonwealth Bank advocates that governments focus on:

- Prioritising their financial capacity for infrastructure investment into new assets.
- Providing support to new developments and effective insurance for early demand risks on a case-by-case basis determined by economic and social needs criteria.
- Creating clear and defined user-pays regimes for infrastructure assets from the earliest possible stage.

## 3. ACCESSING PRIVATE CAPITAL FOR INFRASTRUCTURE FUNDING

### 3.1 Context

The private sector already plays an important role in financing brownfield and greenfield infrastructure projects and has the capacity to increase its participation. In particular, investors will respond as follows:

- Private sector infrastructure equity investment will respond favourably to governments establishing long-term, stable policy frameworks and user-pays models. This will create an appropriate balance between investors' goals around risk, income and capital growth levels as well as broader economic goals for efficient infrastructure costs.
- Private sector infrastructure debt investors will support assets with appropriate balance between revenues (under user-pays or government availability models), expenditure (operating and capital costs) as well as clear principles and timing for regulatory determinations to accommodate duration and refinancing risk.

There are four main sources of private finance for infrastructure investments:

- Direct investments from superannuation funds.
- Private investments, including investments from offshore investors.
- Bank lending.
- Fund raising from capital markets.

Australia competes internationally for private sector finance and requires a regulatory framework and market environment which are attractive to major sources of finance. Commonwealth Bank welcomes initiatives that make private sector infrastructure investments more attractive and accessible. The following sections provide observations on some important issues on this topic.

### 3.2 Superannuation funds' direct investments

Superannuation funds managing households' long-term savings for retirement should have natural demand for infrastructure assets with stable income streams that match long-term investment duration.

However, the allocation from superannuation funds to infrastructure equity and debt assets (and fixed income more broadly) is low when compared with other developed economies.<sup>139</sup> This is primarily a result of the relatively small domestic market for infrastructure equity and for overall fixed income securities. The range of supply and demand factors on domestic fixed income markets have been previously addressed in Chapter 4.

Superannuation funds also face two other challenges to invest in infrastructure or long-term illiquid assets: liquidity constraints, and evaluation and execution capabilities, which are still developing.

#### Liquidity constraint

The philosophy of the superannuation system is to allow members to determine their choice of fund managers and investment mix that they believe can maximise returns. The portability of superannuation funds from one trustee to another and the flexibility to alter investment allocation at any time require superannuation funds to have sufficient liquidity, impeding their ability to invest in illiquid long-term assets.

Liquidity concerns could be reduced by increased listed debt issuance, centralised clearing and simplifying documentation wherever possible to drive price transparency and trading.

There are other possible alternatives to address liquidity constraints but they have wider policy and practical implications which would require careful considerations:

- Reducing the frequency of asset class choice decisions and extending notice periods for the movement of funds could reduce the need of funds to carry extra liquidity. However, this would be a fundamental change to the existing system.
- Backstop structures that provide liquidity buffers to support superannuation funds to meet withdrawals could be offered through government. However, this can produce market distortions that are problematic and difficult to unwind.

#### Still-developing evaluation and execution capabilities

Infrastructure investments require robust evaluation and execution capabilities, including due diligence, risk assessment, pricing and sector expertise. Traditional fund managers are still developing these skills.

Infrastructure debt is a recognised asset class globally and some superannuation funds have established infrastructure debt funds and teams with relevant skill sets to invest on behalf of the fund members. Further development and depth will be required to reach a meaningful scale.

<sup>139</sup> Mercer, FSC, 'Asset allocation of pension funds around the world', February 2014. The Australian superannuation system's allocation to fixed interest is ~25% versus other selected countries' pension fund average of ~50%.

### 3.3 Private investments, including offshore investors

Offshore pension funds have strong interest in Australian infrastructure assets, providing an easy, attractively priced and direct source of funding to fill the demand gap in Australia. In addition, some offshore investors also benefit from a more favourable tax arrangement than domestic capital providers, enjoying a comparative advantage in their cost of capital.

### 3.4 Bank lending

In Australia, bank lending remains the primary source of private debt funding for infrastructure projects. While much of the funding task resides with the four major domestic banks, there are a significant number of foreign banks present in the Australian market with appetite to lend to infrastructure projects, particularly for brownfield projects.

Since the GFC, banks are required to better match asset and liability (funding) maturities. Long-term debt has become more expensive with higher capital requirements to reflect the risk of mismatch between short term funding and long-term lending. As a result, the cost of capital for infrastructure funding is higher, and banks are cautious on tenors, with lending terms typically seven years or less. This has left long-term projects (e.g. 99 years for Port Botany lease or 25 years for a new availability-based road) exposed to refinancing risk with limited or no ability to adjust business revenues for an increase in debt costs.

Given these constraints, it is important that Australian banks are not subjected to excessively stringent capital regimes compared to their global peers which will exacerbate the increased costs for Australian infrastructure projects.

### 3.5 Capital markets

The capacity of equity or debt capital markets to drive volume for infrastructure investment is dependent on the same underlying issues mentioned above for superannuation funds and offshore investors. Steps to reduce 'frictional' issues such as listing, centralised clearing and simplified prospectus processes have the potential to deliver incremental improvements. Debt capital markets also normally require issuers to obtain credit ratings adding complication particularly for greenfield projects.

There are potential credit enhancement structures to assist capital market access including: letters of credit, whereby bondholders or governments provide funding while the banks assess and accept construction risk on an unfunded basis; and subordinated debt, effectively a second-loss instrument ranking ahead of equity and provided in bespoke forms that enhance the investment risk of senior debt.

### 3.6 Initiatives to improve access to private capital for infrastructure funding

Commonwealth Bank welcomes initiatives that make private sector infrastructure investments more attractive and accessible:

- Market to shift to listed debt issuance and centralised clearing. Government to simplify documentation requirements.
- APRA to ensure that Australian banks are not subjected to excessively stringent capital regimes on infrastructure bank debt compared to their global peers.
- Industry to support more credit enhancement structures, e.g. letters of credit offered by banks and subordinated debt offered by companies.
- Australia to grow its fixed income and securitisation markets more broadly (further details in Chapter 4).

## CHAPTER 15: IMPROVE ACCESS TO CREDIT FOR SMES

### SUMMARY

- Small and medium enterprises (SME) are an integral component of the economy. They are an important creator of private sector employment and a large contributor to GDP growth.
- The Council of Small Business Organisation of Australia (COSBOA) and others have expressed the view that the banking system has not provided its members with adequate access to capital, and that pricing of SME business loans is higher than it should be.
- Research shows that access to finance is not a major concern amongst SMEs, and SMEs do in fact have access to finance. Commonwealth Bank is an active and ongoing supporter of SME customers and has continued to provide funding to viable SMEs throughout the credit cycle (including the GFC).
- The higher pricing of business lending is driven by the higher-risk profile of SME businesses relative to individuals or large corporates.
- The start-up segment does experience limitations on access to finance. This is due to the equity-like nature of the risk associated with lending to start-ups.

### RECOMMENDATIONS

- To support SMEs in their general financial management and access to finance, Commonwealth Bank recommends that periodic SME stakeholder forums should be sponsored for the following reasons:
  - To promote and develop a higher level of financial literacy amongst SMEs, including raising awareness about the type of information typically required to progress an application for finance.
  - To facilitate a greater level of understanding of the SME sector's needs and issues within the banking industry.

### 1. CONTEXT

Commonwealth Bank acknowledges the importance of SMEs<sup>140</sup> to the Australian economy. Approximately two million small businesses employ about 49% of the workforce.<sup>141</sup>

In evaluating the role of banks in supporting SMEs, it is important to understand SME needs and the sector's different types and sources of funding. An SME business is typically funded by equity finance (provided by the business owner and other sources such as VC), debt finance (lending typically provided by banks) and/or payment flow finance (provided by creditors, suppliers and banks).

Commonwealth Bank is committed to supporting Australian small business and remains keen to further increase debt finance (lending) to viable businesses in the SME sector. We believe the same to be true for other banks in the financial system.

<sup>140</sup> Commonwealth Bank defines Micro Business as business with turnover less than \$1 million and SMEs as businesses with turnover between \$1 million and \$20 million.

<sup>141</sup> ABA & COSBOA, 'Small Business: Access to Finance report', year to March 2013.

Commonwealth Bank has not constrained or restricted the debt finance funding available to support lending to this vital segment. Throughout the credit cycle including the GFC, Commonwealth Bank has maintained consistent business lending volume<sup>142</sup> and has used consistent credit policies.

Commonwealth Bank has also made substantial investments in improving our service offering (e.g. Everyday Banking) and committed significant resources (including a substantial marketing spend) to develop SME awareness of our capabilities in this strategically important segment of the market. Further information on Commonwealth Bank's support for SMEs is detailed in Appendix V.

Various parties have in recent years raised arguments regarding the availability of financing for SMEs, specifically:

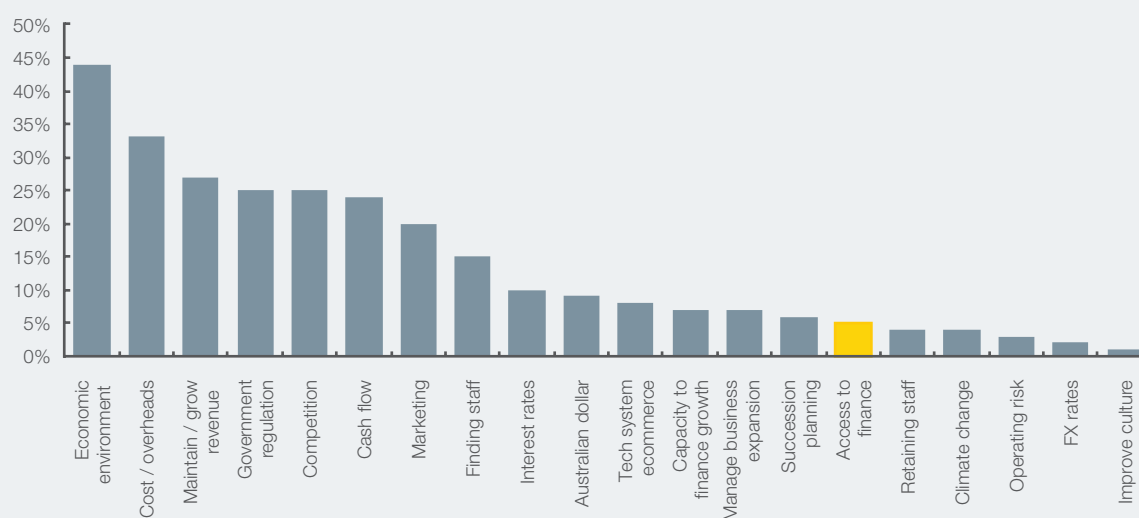
- SMEs find it more difficult to access finance (post-GFC) and entrepreneurship is stifled, suggesting that this is largely the consequence of the banking industry tightening credit policies and lending standards.
- SMEs find pricing of their business loans is higher than it should be:
  - SMEs often use their principal residence as security for their business loan; therefore, it is argued, the interest rate should be the same as if the loan were a retail home loan.
  - SMEs should pay the same interest rate or credit margin as large corporates.

## 2. ACCESS TO FINANCE

To develop a better understanding of the 'access to finance' issue, the Australian Bankers Association (ABA) and member banks in partnership with COSBOA commissioned DBM Consultants in 2013 to conduct a survey of SMEs.

The results of this survey indicate that access to finance is a relatively low priority issue for SMEs – it was ranked 15th out of the top 20 issues (Figure 33).

**Figure 33: Small Businesses – major concerns**



Source: ABA & COSBOA, Small Business: Access to Finance report, year to March 2013.

<sup>142</sup> Commonwealth Bank, 'Pillar 3 statements'.

The media release accompanying the ABA and COSBOA report included the shared observation that:

*“There are only a small proportion of small businesses working in each industry sector which may be planning to expand due to revenue growth and are worried about access to finance”.<sup>143</sup>*

The ABA and COSBOA report also noted that amongst SMEs:

*“There is limited understanding about basic finance issues. For example, the role of debt vs. equity, capacity, character, collateral and the importance of taking responsibility for a loan application and the ongoing relationship with a lender.”<sup>143</sup>*

The ABA and COSBOA report suggests that SMEs do in fact have access to funding sources. Approximately 49% (980,000) have a business lending product other than a credit card and 71% (1.42m) have a lending product when credit cards are included.

Commonwealth Bank supports the banking industry continuing to work with COSBOA, other small business associations and the Government to ensure SMEs have a better understanding of finance and the type of information typically required by lenders to support an application for credit. Commonwealth Bank believes this will increase understanding within the SME community about what sort of financing is suitable for bank lending and what is suitable for equity or mezzanine debt funding.

To this end, the ABA and member banks, in partnership with COSBOA, are developing further information about bank practices to share with SMEs.

### 3. PRICING FOR CREDIT

#### 3.1 Residentially-secured business loans

There are important differences between home loans and business loans, even if they are residentially-secured.

In Commonwealth Bank's experience, small business loans have both a higher probability of default (PD) and a higher loss outcome in the event of default. Banks are therefore required by APRA to hold a higher amount of capital against business loans to absorb potential losses, which comprises a cost.

These costs are reflected in loan pricing via a higher risk margin above the home loan rate.

#### 3.2 Risk-rated pricing for corporates and SMEs

APRA requires banks to apply a risk rate to all business lending activity.

The risk rating applied to a business is a function of the underlying credit quality of the business. The higher the quality of the business, the better the risk rating and therefore the lower the cost of debt finance. Conversely, lower risk ratings have a higher price for debt finance.

Corporate clients tend to have larger and more specialised management teams, stronger balance sheets supported by more equity and better quality and more timely information about their business.

At an aggregate portfolio level, most of Commonwealth Bank's corporate clients are assessed as a higher credit quality than SMEs and therefore they attract a lower cost of borrowing.

The common pricing misperceptions amongst SMEs highlight the need for banks to better communicate with SMEs on the value of information about SMEs in determining how credit is priced.

---

<sup>143</sup> ABA & COSBOA, 'Small Business: Access to Finance report', Media Release, year to March 2013.

## 4. EDUCATING SMES

Given the importance of the SME sector to the Australian economy, Commonwealth Bank **recommends** that the Government:

- Support the development of a higher level of financial literacy amongst the SME market, including providing details about the type of information typically required to progress an application for finance.
- Facilitate a greater level of understanding of the SME sector needs within the banking industry.

The collaborative approach adopted by the ABA and COSBOA in commissioning the 'Small Business: Access to Finance' report in 2013 is a good example of the banking industry's willingness to listen to and respond to identified, data-based issues in the SME market in a constructive and meaningful manner.

Commonwealth Bank believes there is an opportunity for an increased level and frequency of engagement amongst key stakeholders (e.g. ABA, COSBOA, Government, other industry associations) to help address issues in a timely and constructive manner.

## 5. ACCESS TO FINANCE FOR START-UP SMES

### 5.1 Issues

Commonwealth Bank acknowledges that obtaining finance for an SME start-up is a challenge.

A prudent bank lender typically lends money to entities with a demonstrated capacity to service and repay a loan. Start-ups often find it difficult to provide this proof. In these circumstances, lenders have difficulty satisfying prudential lending and other obligations when assessing a credit application, given the lack of historical financial information and/or evidence of capacity to service a loan. Start-up lending carries 'equity-like' risk.

As a result, banks will often look to extend lending for small business start-ups by, for example, allowing equity in other assets to be utilised (e.g. private property). The collateral offered serves as an assurance to both the start-up and the bank that the loan is a responsible extension of credit, whilst also enabling the client to access debt funds rather than more expensive equity (and which may also require the customer to forgo some ownership control).

Other providers of finance accessed by SME start-ups include venture capital (VC), 'business angels' and 'crowd sourcing'. These are all outside the traditional banking industry and arguably form part of the shadow banking market.

### 5.2 Potential solutions

#### Public Private Partnerships

Commonwealth Bank suggests that a 'bridging finance' approach be considered in the form of Public Private Partnerships (PPP) to improve access to funding for eligible SME start-up opportunities. This would introduce a risk-sharing arrangement between the Government and the private sector and could fill the gap between SME finance needs and private sector lending appetite.

A number of other G20 governments have chosen to support their local SME markets and start-up businesses in particular through a form of PPP. The USA, Japan, Korea, Singapore and Canada all have some form of government-sponsored programs or entities to support the development and/or provision of finance to the SME, start-up and/or micro sectors.



In Canada, the Canada Small Business Financing Program (CSBFP) provides support to small business. The CSBFP operates under the Canada Small Business Financing Act (1999) and targets ‘for-profit small and medium size businesses’ with revenues less than C\$5 million.<sup>144</sup> The CSBFP works with lenders to make finance available to eligible SMEs and enters into risk-sharing arrangements between lenders and the government. On average the CSBFP helps small businesses access 10,000 loans worth more than C\$1 billion each year. Importantly, once an eligible SME reaches agreed levels of maturity Commonwealth Bank understands it leaves the CSBFP by sourcing funds directly in the private sector without government support.

There is some Australian Government support for SME startups through Commercialisation Australia (CA). CA is a ‘government backed, competitive, merit-based program offering funding and resource assistance to accelerate the commercialisation of Australian developed intellectual property’.<sup>145</sup>

CA provides eligible program participants with access to management expertise and up to \$2 million in ‘early stage commercialisation’ grants to support the development of business opportunities.

Commonwealth Bank suggests raising awareness of CA’s mandate and offering within the SME community.

### Expand the VC market

A vibrant and successful VC market can promote innovation and be a source of productive economic growth and expanded employment opportunities for Australians.

According to the US National Venture Capital Association (NVCA):

*“While investment in venture-backed companies only equates for between 0.1% and 0.2% of US gross domestic product these companies employed 11% of the total US private sector workforce and generated revenue equal to 21% of US GDP”<sup>146</sup>*

The NVCA states that in the US, the software, biotechnology, semiconductor and electronics sectors provide over 70% of VC-backed jobs.<sup>141</sup>

In contrast, the VC industry in Australia is emerging but remains small; as a consequence, Australian start-ups have often sought funding offshore. In 2013, the VC industry provided new funding of only \$155m, down 35% on 2012. The average VC transaction size in 2013 was \$0.9m.<sup>147</sup>

In addition, smaller scale private VC finance provided by ‘business angels’ (e.g. family, friends and business associates) or ‘crowd sourcing’ is, anecdotally, usually of a lower average amount than that provided by VC firms.

Bank involvement in the VC market is understandably very limited as a significant majority of VC finance is in the form of equity (or equity hybrids). In 2014, 67% of Australian VC funding was invested as equity, 10% as unsecured debt, 6% as secured debt, and the remaining portion as quasi-equity, mezzanine and undisclosed.<sup>147</sup>

The development and expansion of a domestic VC market would help facilitate the development of SME start-ups and potentially create employment opportunities for Australians.

Commonwealth Bank suggests considering how an expanded VC market can assist the development and funding of emerging Australian SMEs.

<sup>144</sup> Industry Canada, ‘About the Program website’, ([http://www.ic.gc.ca/eic/site/csbfp-pfpec.nsf/eng/h\\_la02855.html](http://www.ic.gc.ca/eic/site/csbfp-pfpec.nsf/eng/h_la02855.html)).

<sup>145</sup> Commercialisation Australia.

<sup>146</sup> NVCA, ‘Venture Impact - The Economic importance of Venture Capital-backed Companies to the US Economy 2010’. Companies include Cisco, Google, Apple, Microsoft, eBay, Amazon, Facebook, Twitter, Starbucks, and FedEx.

<sup>147</sup> Australian Private Equity and Venture Capital Association, ‘Annual Report’, 2013.

## CHAPTER 16: ADDRESS UNDERINSURANCE AND SUSTAINABILITY ISSUES IN INSURANCE

### SUMMARY

- Insurance plays a vital role in the financial system by providing financial security to consumers and businesses while reducing pressure on government spending.
- Underinsurance continues to be a prominent issue in Australia, driven mainly by consumer awareness, accessibility and cost.
- An underinsurance burden is typically shifted to governments and the community, creating unexpected pressures on budgets and households.
- The insurance industry also faces other sustainability challenges that are attributable to increasing lapse rates,<sup>148</sup> deteriorating claims experience and rising costs. These impact the cost and affordability of insurance to consumers.
- Support from Government is required to develop a whole-of-industry solution for underinsurance and for maintaining the sustainability of the system.

### RECOMMENDATIONS

#### Addressing underinsurance:

- Improve consumer awareness:
  - Raise awareness of households and businesses about risks and improve their financial literacy about the importance and benefits of insurance.
- Provide easy access to insurance:
  - Continue to support life insurance as a feature of the superannuation system. Trustees and life insurers to be transparent about the level of coverage and benefits.
  - Reduce friction of insurance purchase by modernising and refining consumer disclosure requirements leveraging technology.
- Lower the cost of insurance:
  - Federal, State and Territory Governments to commit to abolishing stamp duties on general insurance.
  - Federal, State, Territory and Local Governments to align policies, natural event planning and risk reduction and information sharing activities to lower the risk profiles of disaster-affected regions. This will help ensure available and affordable cover for those communities.

#### Improving insurance system sustainability:

- Consider changes to the Health Act to allow life insurers to fund rehabilitative treatments to assist claimants to return to work.
- Refine the Insurance Contracts Act to allow insurers to better manage and migrate legacy books.
- Clarify the nature of statutory insurance schemes relative to private disability insurance, and continue to encourage the take-up of private insurance.

<sup>148</sup> A lapse is the cancellation of coverage due to the non-payment of premiums.

## 1. CONTEXT

Insurance plays a vital role in the financial system by providing financial security to consumers and businesses while reducing pressure on government spending. It provides businesses, governments and consumers the ability to intermediate and mitigate risks. This allows insured parties to better focus on their commercial and personal priorities.

Customers continue to benefit from a strong and competitive local insurance market that is well regulated, trusted and dependable. However, the economy and the insurance industry face challenges which need to be addressed in order to maintain the industry's strength, robustness and competitiveness.

## 2. UNDERINSURANCE

### 2.1 Context

Whilst there is no universally accepted measure of the ideal level of insurance, underinsurance remains a prominent issue for the Australian population despite ongoing government and industry efforts.

Demand for insurance is a function of variables including risk awareness, pricing and financial literacy. People have varying risk appetites and can choose to be uninsured because they have other consumption priorities driven by differing circumstances, life experiences and views about the cost of reducing risk relative to other consumption options.

People typically demonstrate strong loss aversion and a propensity to mitigate insurable risks when given the opportunity to do so.

Despite this propensity, it is a challenge to estimate the extent of insurance needed, because the probability of events, along with the possible impact and the benefits of insurance, are not easily assessed in a comprehensive or objective manner. This benefit-perception gap, combined with a range of behavioural biases, can have the effect of inhibiting the optimal demand for insurance.

Rice Warner research concluded that Australians do not have enough life insurance. The median level of life cover is only 66% of basic needs and 41% of the amount needed to ensure beneficiaries/dependents can maintain their standard of living in case of their parent's or spouse's death.<sup>149</sup> For general insurance, Quantum Market Research estimates that about 23% of homeowners and renters have no cover, and 80% are underinsured for home and contents.<sup>150</sup>

The FSC and KPMG have estimated the cost of underinsurance against disability as \$304 billion per year for the employed. This equates to 63% of the adequate insurance needs unmet through existing policies.<sup>151</sup>

Remedies for underinsurance include lifestyle adjustments, reliance upon personal savings and assets, assistance from family and friends, government welfare and social programs, charities and debt.

While the insurance industry has a clear incentive to address underinsurance, there are aspects of the policy environment that can be improved to better address underinsurance. If Australians were adequately insured, social security benefits could be reduced and households could also have the peace of mind that they are protected from undesirable events.

The following sections discuss recommendations for addressing underinsurance.

<sup>149</sup> Rice Warner, 'Underinsurance in Australia', 2013.

<sup>150</sup> Quantum, 'The Understand Insurance Research Report', Market Research, October 2013.

<sup>151</sup> FSC and KPMG, 'Underinsurance – Disability Protection Gap in Australia', January 2014.

## 2.2 Improving customer awareness

As mentioned above, consumer demand for insurance in Australia is limited by competing purchase demands and prioritisation of needs. Consumers are also biased towards risk-taking behaviours due to limited understanding of risks, while the benefits of insurance are often difficult to quantify. This can be a function of a low level of financial literacy.

In response, the insurance industry has supported a number of education campaigns. For example, [understandinginsurance.com.au](http://understandinginsurance.com.au) is a recent industry initiative designed to help consumers understand the purpose and importance of insurance as well as the different insurance products available.

Commonwealth Bank **recommends** further financial literacy programs to educate consumers about the purpose and importance of insurance. Details on improving financial literacy are detailed in Chapter 13.

## 2.3 Providing ease of access to insurance

### Continuing the demand ‘push’ from superannuation

The take-up of insurance is not always demand-led. Superannuation has historically played a key role in the provision of affordable life insurance coverage to a large segment of the workforce. Insurance has been offered within superannuation under the SIS Act since its inception in 1993 under the Sole Purpose test.

The arrangement provides consumers with choice about whether to fund their insurance inside or outside superannuation. We support the existence of this level of ‘choice’ and believe it is consistent with the overall policy settings which apply to the retirement savings system.

Superannuation members enjoy better pricing as a result of the scale achieved under a group policy and more favourable automatic eligibility than they would otherwise have under a personal contract.

Critics of this arrangement have argued that insurance premiums could erode retirement savings. Commonwealth Bank believes that under Prudential Standard SPS 250 trustees have the same obligation to consider the members’ insurance strategy as they would for members’ investments. Trustees should also consider the potential for poor retirement and beneficiary outcomes as early death or prolonged disability could erode retirement savings if no or insufficient insurance is in place. These events have been addressed in the SIS Act’s ‘conditions of release’ for superannuation benefits.

Removing insurance from superannuation would be likely to increase the level of underinsurance as members will be required to make a proactive choice outside the superannuation environment. The cost of insurance would have to be deducted from an individual’s disposable income and the application process would be more complicated and intrusive.

Removing insurance from superannuation would also create more complexity and cost for trustees, which may ultimately be passed on to members. Grandfathering provisions for those currently covered, particularly those who are now uninsurable but have current cover through the superannuation arrangement, would need to be considered. This would exacerbate the legacy products issues in the market, as further detailed in 3.3.

Commonwealth Bank **recommends** life insurance continues to be an option within the superannuation system to support wider insurance coverage. Superannuation trustees and life insurers should be transparent about the benefits available through the arrangement to address the common misperception of sufficient coverage.

## Reducing the friction from onerous disclosure requirements

Barriers to insurance can arise due to the onerous disclosure requirements for consumers, advisers and product manufacturers, particularly for life insurance.

Insurance industry participants have improved the process and ease of communication with customers, particularly by utilising new technologies. Yet difficulties remain in making information available to consumers electronically. This is due to the practical effect of the Electronic Transactions Act, the Corporations Act, the Insurance Contracts Act, and the Life Act.

Commonwealth Bank **recommends** reducing friction of insurance purchase by modernising and refining consumer disclosure requirements for insurance products via various forms of technology. This allows effective disclosure to consumers with minimal transferred costs. Further details on simplifying and modernising disclosure requirements are contained in Chapter 8.

## 2.4 Reducing cost of insurance

### Removing coexistence of tax charges from Federal and State governments

Despite underinsurance being a prominent public policy issue, general insurance can be a price-driven decision each year whether to renew, switch or lapse and consequently self-insure. One of the additional cost factors adding to total premium is the co-existence of the Goods and Services Tax and stamp duties for general insurance.

Commonwealth Bank **recommends** that State Governments commit to abolishing stamp duties on general insurance products to improve affordability, in line with the recommendations of the Johnson Report<sup>152</sup> and the Intergovernmental Agreement.<sup>153</sup>

### Reducing cost of general insurance for natural disaster-prone areas

The availability and affordability of general insurance are impacted by the growth in claims arising from natural disasters.

On average, the Australian community spends \$1.58 billion each year in recovering from natural disasters.<sup>154</sup> The government bill alone in the 2010/11 summer was estimated to be more than \$5.6 billion.

In addition, pricing and policy conditions of general insurance are increasingly able to be delivered on a localised and frequently updated basis, reducing cross subsidisation and passing increased insurance costs to customers in higher risk areas.

Commonwealth Bank acknowledges that a National Partnership Agreement worth \$52 million was signed between the Federal, State and Territory Governments in March 2014 to support investment in mitigation projects. Commonwealth Bank **recommends** that the State and Federal Governments continue to combine efforts to lower the risk profile of risk-prone areas and hence improve availability and affordability of insurance. Governments can align policies (e.g. town planning requirements that discourage new buildings in high risk areas, requirements for new buildings in marginal areas to satisfy certain resiliency standards), further mitigate risks for buildings that exist in high risk areas and continue to invest in disaster mapping capability to provide more reliable data.

<sup>152</sup> The Australian Financial Centre Forum, 'Australia as a Financial Centre', November 2009.

<sup>153</sup> Council of Australian Governments, 'Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations', 25 June 1999.

<sup>154</sup> Australia Strategic Policy Institute, 'Sharing risk – Financing Australia's Disaster Resilience', February 2011.

### 3. OTHER SUSTAINABILITY CHALLENGES

#### 3.1 Context

The insurance industry is experiencing discontinuance rates<sup>155</sup> which are at a 20-year high.<sup>156</sup> Survey data shows that customers identify affordability as one of the key reasons for allowing policies to lapse.<sup>157</sup> Household financial pressures, rising premium costs and changing consumer preferences are contributing to this.

The insurance industry itself also faces sustainability challenges including deteriorating claims experience and rising costs, which impact the cost and affordability of insurance to consumers.

Developing solutions to sustain the market and to make insurance more affordable and accessible requires a whole-of-industry response which is supported by Government. The following sections discuss the recommendations for maintaining the sustainability and efficiency of the insurance sector.

#### 3.2 Improving claims experience

##### Supporting disabled claimants to return to work

Life insurers are limited by legislative provisions in their capacity to pay for rehabilitative treatments that would assist claimants to return to work. This leads to higher ongoing benefit payments and claims administration costs, which then flow through to higher premiums.

Commonwealth Bank **recommends** a review of the Health Act to allow life insurers to fund rehabilitative treatments and assist workers in their return to the workplace.

##### Ensuring a fair claims management and dispute resolution process

There has been an increasing number of new insurance claims notified and lodged directly by plaintiff law firms on behalf of claimants, bypassing superannuation trustees' normal claims lodgement processes, leaving little opportunity for trustees and insurers to appropriately assess the claim before legal actions are threatened.

This leads to both an increase in claims management costs and to poor customer outcomes where claims are normally paid by the insurer but the claimant incurs legal fees thus reducing their superannuation payouts.

Even in the scenario where a claim is contested by the trustee or insurer, this approach can undermine the purpose for which the Superannuation Complaints Tribunal (SCT) and Financial Ombudsman Service (FOS) bodies were established (to provide claimants with the opportunity to first access a free external dispute resolution process).

Commonwealth Bank suggests reviewing the increasing levels of insurance litigation with a view to enhancing the claims management and dispute resolution processes.

#### 3.3 Managing rising costs

##### Reducing burden from legacy books

As discussed in Chapter 10, the superannuation and insurance industry face a significant burden from the maintenance of legacy books, which increases operating costs that are ultimately passed on to policyholders.

<sup>155</sup> Includes lapses, surrenders and forfeitures. Lapses make up a large proportion of discontinuances.

<sup>156</sup> Plan For Life, 'Risk Market Discontinuances Peaking at 16.7% Sep-13', 30 January 2014.

<sup>157</sup> Commlinsure, 'Understanding reasons for policy lapses', Internal online survey, 2013.

Commonwealth Bank **recommends** continuous development of a robust product rationalisation process and building upon recent refinements to the Insurance Contracts Act to allow insurers to better manage outdated products. This will reduce costs, increase efficiency and offer products which are more relevant to customers.

### Exempting insurers from the anti-discrimination law

The Australian Law Reform Commission is currently reviewing Commonwealth anti-discrimination laws. Commonwealth Bank is part of the formal consultation process. The present exemptions under the Age, Gender and Disability Discrimination Act help to safeguard the affordability of insurance and premiums reflecting underlying risk.

These exemptions should continue to be retained to protect the consumer and to limit any cross subsidisation from one group to another.

## 3.4 Addressing market disruptions

The Government has commenced implementation of the National Disability Insurance Scheme (NDIS) and the National Injury Insurance Scheme (NIIS) to directly provide long term care and support for those who have or sustain a serious permanent disability. These programs may be classified as social security or welfare programs for those who are significantly and permanently affected in their communication, mobility, and the ability to self-care or self-manage.

Misconceptions around Government 'insurance' schemes could lead to higher opt-outs from private insurance and increased risk-taking by insured parties.

Commonwealth Bank considers the Government schemes as complementary to existing private insurance products that households choose to buy. Private insurance has different eligibility criteria (also covering less severely or temporarily affected individuals) and forms of payout (lump sum or monthly benefits) which allow for flexibility in managing one's own finances and maintenance of lifestyles.

Commonwealth Bank **recommends** clarification on the nature of statutory insurance schemes, particularly in comparison to private insurance, and continued encouragement to take up private insurance. This will decrease pressure on public schemes and support the viability of private insurance.



# GLOSSARY

TERM	DEFINITION
AAL	Automatic acceptance limit
ABA	Australian Bankers Association
ABCP	Asset-backed commercial paper
ABS	Asset-backed securities
ABS	Australian Bureau of Statistics
ACC	Australian Crime Commission
ACCC	Australian Competition and Consumer Commission
ADI	Authorised deposit-taking institution
AML	Anti-money laundering
AOFM	Australian Office of Financial Management
APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
AUSTRAC	Australian Transaction Reports and Analysis Centre
AVCAL	Australian Private Equity and Venture Capital Association
BCBS	Basel Committee on Banking Supervision
BICRA	Banking Industry Country Risk Assessment
bps	Basis points
CA	Commercialisation Australia
CBS	Core banking system
CDS	Credit default swap
CET1	Core equity tier 1
CGS	Commonwealth Government securities
CLF	Committed liquidity facility
COFR	Council of Financial Regulators
COSBOA	Council of Small Business Organisation of Australia
CSBFP	Canada Small Business Financing Program
CSIRO	Commonwealth Science and Industry Research Organisation
D-SIB	Domestic systemically important bank
DVS	Document Verification Service
FATCA	Foreign Account Tax Compliance Act
FCS	Financial Claims Scheme
FOFA	Future of Financial Advice
FOS	Financial Ombudsman Service
FSC	Financial Services Council
FSR	Financial Services Reform
FWC	Fair Work Commission
GDP	Gross domestic product
GFC	Global Financial Crisis
HHI	Herfindahl-Hirschman Index
HQLA	High quality liquid assets
IAA	Institute of Actuaries of Australia

IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
KYC	Know your customer
LHS	Left hand side
MFI	Main financial institution
NBN	National Broadband Network
NDIS	National Disability Insurance Scheme
NFC	Near field communications
NFLS	National Financial Literacy Strategy
NICTA	National Information Communications Technology Australia
NIIS	National Injury Insurance Scheme
NPP	New Payments Platform
NSTIC	National Strategy for Trusted Identities in Cyberspace
NVCA	National Venture Capital Association
OAIC	Office of the Australian Information Commissioner
OBPR	Office of Best Practice Regulation
OTC	Over-the-counter
P2P	Peer-to-peer
PD	Probability of default
PIA	Privacy impact assessment
PIR	Post-implementation review
PPF	Purchased Payment Facility
PPP	Public-Private Partnership
PSB	Payments System Board
RBA	Reserve Bank of Australia
RCAP	Regulatory Consistency Assessment Programme
RE	Responsible Entity
RHS	Right hand side
RIA	Regulatory impact assessment
RIS	Regulatory impact statement
RITS	Reserve Bank Information and Transfer System
RMBS	Residential mortgage-backed securities
RoE	Return on equity
RSE	Registrable Superannuation Entity
RTGS	Real-time gross settlement
S&P	Standard & Poor's
SAF	Small APRA fund
SCT	Superannuation Complaints Tribunal
SGC	Superannuation Guarantee Contribution
SIS	Superannuation Industry (Supervision) Act 1993
SME	Small and medium enterprise
SMSF	Self-managed superannuation fund
SOE	Statements of expectations
STF	Suppression of Terrorism Financing
TAFE	Technical and further education
TBTF	Too big to fail
VC	Venture capital
VET	Vocational education and training

# TABLE OF FIGURES

FIGURE	PAGE
FIGURE 1: GDP GROWTH OF SELECTED COUNTRIES	10
FIGURE 2: INVESTMENT AND SAVINGS OF SELECTED COUNTRIES	11
FIGURE 3: AUSTRALIA'S SAVINGS AND INVESTMENT RATES	11
FIGURE 4: FINANCIAL DEVELOPMENT INDEX	12
FIGURE 5: INTERNATIONAL PEER BASEL III CORE EQUITY TIER 1 (CET1) RATIO	13
FIGURE 6: CONTRIBUTION TO THE ECONOMY BY INDUSTRY TYPE	14
FIGURE 7: GROWTH IN GROSS LOANS AND ADVANCES	16
FIGURE 8: EXAMPLES OF PLAYERS BY PRODUCT SEGMENT (EXCLUDING THE FOUR MAJOR BANKS)	19
FIGURE 9: AUSTRALIAN BANKING HERFINDAHL-HIRSCHMAN CONCENTRATION INDEX	20
FIGURE 10: RELATIONSHIP BETWEEN FINANCIAL SYSTEM CONCENTRATION AND SIZE OF THE ECONOMY	20
FIGURE 11: RETAIL BANKING SECTOR INDUSTRY AVERAGE CUSTOMER SATISFACTION	21
FIGURE 12: AVERAGE BUSINESS BANKING SECTOR CUSTOMER SATISFACTION FOR MAJOR AND SELECTED REGIONAL BANKS	21
FIGURE 13: MULTIFACTOR PRODUCTIVITY GROWTH	22
FIGURE 14: COST TO ASSET RATIO OF MAJOR BANKS	22
FIGURE 15: BANK FEES	22
FIGURE 16: BANKS' NET INTEREST MARGIN	23
FIGURE 17: COMMONWEALTH BANK RETAIL BANKING SERVICES NET INTEREST MARGIN	23
FIGURE 18: COMMONWEALTH BANK CDS PRICING DURING AND SINCE THE GFC	35
FIGURE 19: COVERED BOND LIMITS – AUSTRALIA AND PEER JURISDICTIONS	41
FIGURE 20: CDS PRICING – COMMONWEALTH BANK AND PEER BANKS	43
FIGURE 21: COMMONWEALTH BANK COMMON EQUITY TIER 1 RATIO UNDER VARIOUS REGULATORY REGIMES	45
FIGURE 22: COMMONWEALTH BANK VERSUS PEERS IN DEVELOPED MARKET JURISDICTIONS	46
FIGURE 23: CDS (5-YEAR SENIOR) PRICING – RBS AND LLOYDS VERSUS UK GOVERNMENT	49
FIGURE 24: COMMONWEALTH BANK NUMBER OF INTERNET TRANSACTIONS	57
FIGURE 25: COMMONWEALTH BANK INNOVATION TIMELINE, 1981 TO 2014	57
FIGURE 26: AUSTRALIAN CHEQUE USAGE	68
FIGURE 27: ESTIMATED ANNUAL EXPENDITURES DURING RETIREMENT	80
FIGURE 28: SUPERANNUATION LUMP SUM AMOUNTS REQUIRED TO FUND RETIREMENT	80
FIGURE 29: LUMP SUM RETIREMENT BENEFITS FOR A SINGLE PERSON AFTER 30 YEARS OF CONTRIBUTION	81
FIGURE 30: PROPORTION OF RETIREES TAKING AN INCOME STREAM	83
FIGURE 31: IMPEDIMENT AND POTENTIAL SOLUTIONS FOR DEVELOPING INCOME STREAM PRODUCTS	84
FIGURE 32: ILLUSTRATION OF A CUSTOMER'S LIFECYCLE	98
FIGURE 33: SMALL BUSINESSES – MAJOR CONCERNS	107

# **WELLBEING, RESILIENCE AND PROSPERITY FOR AUSTRALIA**

## **FINANCIAL SYSTEM INQUIRY (APPENDIX)**

**March 2014**



# TABLE OF CONTENTS

---

## APPENDIX I

---

CHAPTER 5: ENABLE COMPARABILITY  
OF AUSTRALIAN BANK CAPITAL  
RATIOS TO INTERNATIONAL  
PEERS (a) **122**

## APPENDIX II

---

CHAPTER 5: ENABLE COMPARABILITY  
OF AUSTRALIAN BANK CAPITAL  
RATIOS TO INTERNATIONAL  
PEERS (b) **123**

## APPENDIX III

---

CHAPTER 9: ENSURE PAYMENT  
SYSTEMS SECURITY **125**

## APPENDIX IV

---

CHAPTER 12: IMPROVE EFFICIENCY  
AND ADAPTABILITY OF THE  
REGULATORY SYSTEM **127**

## APPENDIX V

---

CHAPTER 15: IMPROVE ACCESS  
TO CREDIT FOR SMES **129**

# APPENDIX I

## Chapter 5: Enable Comparability of Australian Bank Capital Ratios to International Peers (a)

### 1. COMPARISON OF APPLICATION OF BASEL STANDARDS

**Figure 1: Comparison of APRA application of Basel III Capital Framework against peer jurisdictions**

Difference	Australia	Canada	UK	Capital Requirements Directive IV <sup>1</sup>	Singapore	South Africa
Apply downturn LGD assumption to mortgages (offset by recognition of lender's mortgage insurance)	x	√ <sup>2</sup>	√	√	√	√
Investment home loans measured under corporate methodology	x	√	√	√	√	√
Slotting not required for Specialised Lending (higher average risk weights) <sup>3</sup>	x	√ <sup>4</sup>	x <sup>5</sup>	√	x	√
Less than 100% EAD assumptions allowed for commercial credit	x	√	√	√	√	√
Less than 60% LGD assumptions allowed for unsecured commercial credit	x	√	√	√	√	√
45% LGD on Sovereign exposures	x	x	√	√	x	x

Source: Commonwealth Bank, PwC, Morgan Stanley.

1. Applies to most European Union countries.

2. Canadian Lender's Mortgage Insurance is supported by government guarantee.

3. Specialised Lending includes commercial property, object finance and project finance exposures.


4. A narrow definition of specialised lending exposures has been implemented.

5. UK banks are in the process of moving Specialised Lending exposures from AIRB to the slotting methodology for the commercial property category only.

# APPENDIX II

## Chapter 5: Enable Comparability of Australian Bank Capital Ratios to International Peers (b)

### 1. COMPARISON OF CAPITAL RATIOS UNDER APRA MINIMUM REQUIREMENTS AND THE BASEL III CAPITAL FRAMEWORK


Fact sheet

**Comparison of APRA and the Basel Committee on Banking Supervision Basel III capital ratios**

In implementing the Basel III capital framework in Australia, APRA has elected to adopt a more conservative approach than the Basel Committee on Banking Supervision (BCBS) Basel III minimum requirements. APRA is also adopting an accelerated timetable for the implementation of the Basel III capital framework.

As a result APRA Basel III capital ratios published by Australian banks are not directly comparable to the published capital ratios of international banks. To assist the market in comparing the Basel III capital ratios of Australian banks with those of international banks, Australian banks will publish fully implemented internationally harmonised Basel III capital ratios (based on the BCBS Basel III minimum requirements).

APRA is expected to consult on Basel III disclosure requirements during 2013 and this may include disclosure of the both APRA and internationally harmonised Basel III capital ratios. In the meantime, the table below provides an explanation of the key differences between APRA's Basel III capital rules and the BCBS Basel III minimum requirements and the impact of converting APRA Basel III capital ratios to fully implemented internationally harmonised Basel III capital ratios focussing on Common Equity Tier 1 capital (CET1) ratios. This fact sheet does not cover differences in transitional arrangements between APRA and the BCBS Basel III minimum requirements. This fact sheet may be revised once APRA concludes its consultation on Basel III disclosure requirements.

Key differences relating to the definition of CET 1	Movement in CET 1 ratio from APRA Basel III to internationally harmonised Basel III
<b>Equity investments</b> The BCBS Basel III minimum requirements provide concessional thresholds before a 100% deduction is required from CET1 for equity investments in financial institutions and entities that are deconsolidated for regulatory purposes (eg. insurance and funds managements businesses). APRA requires these equity investments to be deducted fully from CET1.	Increase ratio
<b>Deferred tax assets</b> The BCBS Basel III minimum requirements provide for concessional thresholds before a 100% deduction is required from CET1 for deferred tax assets relating to temporary differences. APRA requires all deferred tax assets, including those relating to temporary differences, to be deducted fully from CET1.	Increase ratio
<b>Capitalised expenses net of deferred fee</b> APRA requires capitalised expenses net of deferred fee income to be deducted from (or added to) CET1. The BCBS Basel III minimum requirements	Increase or decrease ratio

Important Note: This fact sheet gives information of a general nature and is not intended to be relied on by readers as advice in any particular matter. Readers should contact their own advisers on how this information may apply to their circumstances.



Income	do not provide for any adjustments to CET1 for capitalised expenses net of deferred fee income.	
Treasury shares	Under the BCBS Basel III minimum requirements investments in a bank's own shares are required to be deducted from CET1. APRA does not require these to be deducted from CET1 if they relate to employee share-based remuneration schemes (subject to prescribed conditions).	Decrease ratio
Key differences relating to risk weighted assets		Movement in CET1 ratio from APRA Basel III to internationally harmonised Basel III
Interest rate risk in the banking book	APRA requires banks to determine risk weighted assets (RWAs) for interest rate risk in the banking book. The BCBS Basel III minimum requirements make no reference to RWAs for interest rate risk in the banking book.	Increase ratio
Downturn loss given default (LGD) for mortgage portfolios	APRA imposes a floor of 20 per cent on the downturn LGD used in advanced credit models for determining credit RWAs for residential mortgages. The BCBS Basel III minimum requirements impose a downturn LGD floor of 10 per cent for these exposures. The BCBS LGD floor also has a flow on impact on the calculation of expected loss for these exposures, which impacts the capital deduction relating to expected loss in excess of eligible provisions.	Increase ratio
Specialised lending/slotting	APRA requires the supervisory slotting approach be used in determining credit RWAs for project finance, object finance, income-producing real estate, and commercial real estate exposures. The BCBS Basel III minimum requirements allow the advanced internal ratings based approach to be used in determining credit RWAs for these exposures. The internal ratings based approach also has a flow on impact on the calculation of expected loss for these exposures, which impacts the capital deduction relating to expected loss in excess of eligible provisions.	Increase ratio

Created: December 2012

**Any other questions?**

For further information, please contact ABA Director - Industry Policy & Strategy, Tony Burke on 02 8298 0409, e-mail [tony.burke@bankers.asn.au](mailto:tony.burke@bankers.asn.au) or write to the ABA at Level 3, 56 Pitt Street, Sydney, NSW 2000.

Internet: [www.bankers.asn.au](http://www.bankers.asn.au)

Ph: 02 8298 0417

Fax: 02 8298 0402

# APPENDIX III

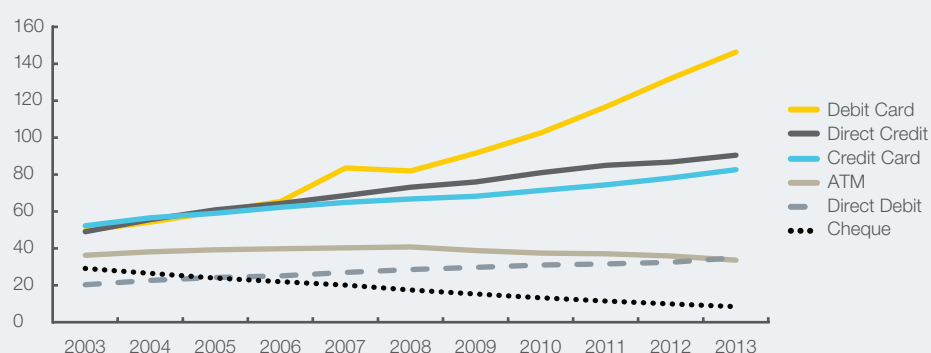
## Chapter 9: Ensure Payment Systems Security

### 1. THE TRANSITION FROM CASH TO ELECTRONIC PAYMENTS

Just as consumers have been migrating from cheque to electronic payments for well over a decade, consumers are now beginning to adopt electronic payments as a replacement for cash payments. This trend is to be both expected – electronic payments are far more convenient for consumers – and encouraged – electronic payments are more efficient than paper-based payments. Commonwealth Bank expects the convenience and efficiency of digital payments to increase as new mobile payment technologies come to market.

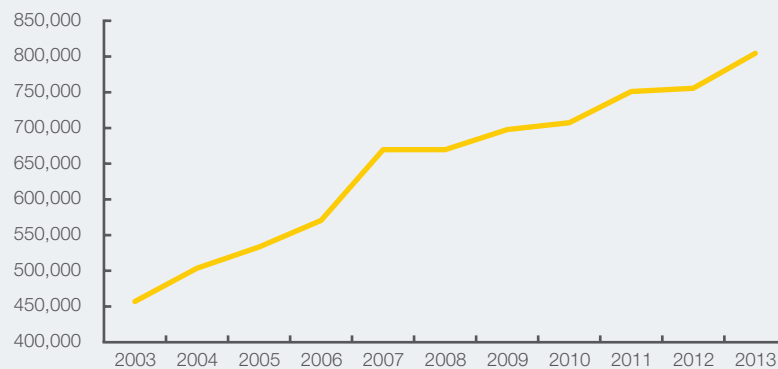
The decline in cash payments is becoming visible in the declining number of ATM withdrawals.

**Figure 2: Number of payments per capita - Australia**



Source: ABS, RBA.

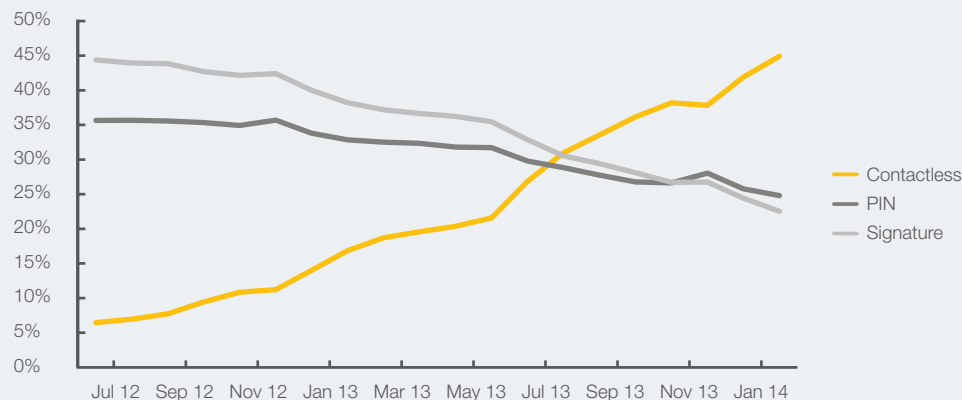
Merchants are increasingly accepting card payments at the point of sale, as evidenced by the steady incline in the number of EFTPOS terminals in Australia. The availability of EFTPOS facilities more broadly amongst the merchant community, in particular small retailers, has lifted card usage. Card usage has risen significantly over the last decade relative to cash, as proxied by ATM transactions.

**Figure 3: Number of EFTPOS terminals**

Source: APCA.

The emergence of contactless payments has further boosted the convenience of card usage. As more mobile payment instruments are deployed, including NFC payment via the CommBank app and contactless payment via CommBank PayTag, this will enhance the appeal of contactless payment.

Usage of contactless cards, phones and stickers to make payments has increased notably since late 2012. This is largely a result of widespread deployment of contactless readers at retailers; most card issuers had already upgraded the bulk of their card fleet to contactless. In the 18-month period from August 2012 to February 2014, the number of contactless PayPass transactions under \$100 made by Commonwealth Bank cardholders as a proportion of all MasterCard point of sale transactions increased from 7% to 45%.

**Figure 4: Authorisation method used by the Commonwealth Bank MasterCard cardholders, as a % of point of sale transactions**

Source: Commonwealth Bank.

Coles has disclosed that 50% of its Visa and MasterCard payments are contactless. For debit cards, it amounts to 60%.<sup>1</sup> This is an insight into how rapidly consumers are embracing contactless payment, and the extent to which it is making inroads into traditional payment methods. Contactless debit card payments are a logical substitute for cash.

As part of the Government's support for growth of the digital economy, Commonwealth Bank **recommends** the Federal Government participates in the education of Australian businesses about the efficiencies of electronic payment over cash. We also **recommend** that Federal, State and Local Governments promote the acceptance of electronic payments over cash amongst their own operations.

We do not expect cash payments to cease anytime soon. In fact, there may always be a residual demand for cash as a means of emergency payment, and amongst those with a distrust of technology or privacy concerns.

<sup>1</sup> Contactless Payments Climb Quickly, Banking Day, 15 May 2013.

# APPENDIX IV

## Chapter 12: Improve Efficiency and Adaptability of the Regulatory System

### CASE STUDY – OTC DERIVATIVES TRADING REFORM

In 2009 the G20 members committed to substantially reforming the practice of OTC derivatives trading markets. The three key G20 commitments made were:

- Reporting of transaction information on OTC derivatives to trade repositories (trade reporting).
- Clearing of standardised OTC derivatives through central counterparties (central clearing).
- Execution of standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate (trade execution).

Although all G20 members agreed in principle to the three commitments, implementation of these principles has varied widely across jurisdictions. The result has been significant business uncertainty, complexity and cost.

Particular examples of implementation issues around OTC derivatives reform include the following:

- Unrealistic deadlines: Achieving full implementation across jurisdictions by 2012, as originally agreed, was unachievable. As recently as February 2014, European jurisdictions expressed concerns that the industry is not ready to implement the new reporting regime of derivatives trades under the European Market Infrastructure Regulation (EMIR). Earlier engagement with market participants would likely have produced a more reasonable implementation timetable.
- Lack of consistent implementation timelines: Jurisdictions are implementing OTC derivative commitments at different times and stages, complicating efforts at global coordination to create cost effective, consistent solutions across regions.
- Lack of guiding principles: Regulations have not been formulated based on common, overarching principles, leaving practical implementation up to interpretation in each jurisdiction. This includes different definitions and different 'triggers' for transactions and events, creating complexity and cost.
- Conflict of laws: Whilst 19 FSB members have committed to OTC derivatives trading reform, the Australian Banking Association has identified potential conflicts of laws arising in 17 member nations. No multi-lateral mechanism is available to address and resolve these potential conflicts, resulting in bi-lateral (and potentially competing) agreements between jurisdictions. These bi-lateral agreements create opportunity for regulatory arbitrage and are inefficient in managing derivatives trading.

## 1. LESSONS FROM GLOBAL OTC DERIVATIVES TRADING REFORM

### 1.1 Context

The OTC Derivatives Regulators Group, an international group of market participants including regulators and supervisors, is developing a framework for cross border regulation and has provided a number of recommendations, including the following tenets:

- Early and comprehensive consultation among relevant authorities of affected countries.
- Flexible, transparent and consistent approaches toward equivalence and substituted compliance.
- Adoption of appropriate transition measures and periods.
- Clear and transparent implementation timeframes and processes to ensure minimal disruption.

IOSCO has also established a Cross Border Regulation Taskforce seeking to engage with industry associations in various countries, including Australia, to find solutions which will address the cross-border implications of national reforms and to coordinate efforts across jurisdictions. This may present a further opportunity to promote a harmonised global framework for OTC derivatives trading regulation.

### 1.2 Cooperation within Australia

Australian regulators have engaged positively with market participants regarding reforms in the domestic OTC derivatives market. Australian regulators have also actively engaged with their overseas counterparts on behalf of all market participants in the Australian derivatives market on matters such as Substituted Compliance/Equivalence. These efforts are to be applauded and encouraged.

Commonwealth Bank acknowledges that the views and concerns of Australia's derivative market participants are well-represented by Australian regulators on the international stage, particularly by ASIC Chairman Greg Medcraft within IOSCO. Commonwealth Bank views this as a significant opportunity for Australia to actively influence the global regulatory landscape. Australian regulators are also represented on other key international groups that are influential in shaping and harmonising global regulation such as the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, and the Financial Stability Board.

Commonwealth Bank remains committed to engaging with regulators on these and other global regulatory topics.

# APPENDIX V

## Chapter 15: Improve Access to Credit for SMEs

### 1. THE COMMONWEALTH BANK'S SUPPORT FOR SMEs

Commonwealth Bank is committed to providing a reliable, consistent and valued service proposition to viable SME clients. Commonwealth Bank has invested in ongoing customer research to understand the sector's key 'pain points' and needs. The findings from this research have shaped the evolution of our service delivery and innovation.

The two main 'pain points' for SME owners identified in our research are as follows:

- Lack of time in general.
- Lack of control over cash flow and in particular incoming payments.

Commonwealth Bank continues to invest in the evolution of our service offering to the SME sector, recognising that about half of all SMEs have no lending requirements (excluding credit cards). As such, Commonwealth Bank is committed to providing and enhancing a 'whole of banking' (i.e. not just lending-focused) service proposition to the SME market.

Commonwealth Bank has developed and introduced innovative and simple-to-use finance solutions to improve the cash flow management of SME clients. The provision of same-day value on EFTPOS transactions through our 'Everyday Settlement' functionality is a market-leading example of our commitment. More innovation is in prospect for the SME market.

Furthermore, Commonwealth Bank has simplified the credit application process for SMEs through the introduction of the following:

- Simplified Business Overdraft process for overdrafts up to \$50,000.
- "Abbreviated Business Credit Decision" (ABCD) process for asset finance, reducing response times for customers.
- Enhanced on-line functionality for business credit cards applications and limit increases.
- A personal liability business credit card.

We have also invested in the education of SME clients through the Small Business Forums program. These forums are free to attend and available to both Commonwealth Bank and non-Commonwealth Bank customers. They have covered topics of value to businesses such as technology and innovation and cash flow management.

We have also improved the accessibility to SMEs of business and industry information designed to help them better manage their businesses. This has been achieved in part through the development of online publications and content such as our e-Zine, webcasts, tools and calculators.

More recently Commonwealth Bank has also provided SME clients with access to free analytics to help businesses develop a better understanding of their customers and improve their business performance (e.g. Better Business Insights Report, Daily iQ). We also provide regular economic analysis (e.g. Business Sales Indicator, Future Business Index) often tailored for the SME market.

SME clients of Commonwealth Bank are invited to undertake free business 'health checks' to ensure businesses have the most appropriate banking products and services to meet their goals.

Commonwealth Bank is committed to ensuring we provide a market leading service to the Micro and SME segments.





## END NOTE

'Total Banks' in Figure 11 include: Adelaide Bank, AMP, ANZ, Arab Bank Australia, Bank of Melbourne, Bank of New Zealand, Bank of Queensland, Bank SA, Bankmecu (incl. mecu) (from October 11), BankVic (incl. Police Association Credit (VIC)) (from July 13), BankWest, Bendigo Bank, Beyond Bank Australia (incl. Community CPS/Alliance One/Companion/United (WA)) (from October 13), BNP, Paribas, Citibank, Commonwealth Bank (excl. Woolworths Ezy Banking), CommSec (from August 12), Defence Bank (incl. Defence Force Credit) (from March 12), Deutsche Bank, Elders, Esanda, Heritage Bank (incl. Heritage B.S.) (from March 12), HSBC, ING Direct (revised December 10), Macquarie, ME Bank (Members Equity) (revised October 11), National Australia Bank (nab), P&N Bank (incl. Police & Nurses (WA)) (from March 13), Police Bank (incl. Police Credit Union (NSW)) (from July 13), QTMB (QT Mutual Bank) (incl. Queensland Teachers') (from March 12), Rabobank, RaboDirect (from October 13), Rural Bank (from October 11), St George, Suncorp Bank (revised October 11), Teachers Mutual Bank (incl. NSW Teachers/Teachers Credit Union) (from April 12), TIO, UBank, Victoria Teachers Mutual Bank (incl. VTU) (from April 12), Westpac, Advance Bank (now merged with St. George Bank) (until September 11), BT (was Bankers Trust) (until September 11), Challenge Bank (until September 11), Colonial State Bank (was known as State Bank of NSW) (until September 11), dragondirect (until September 11), Metway Bank (until September 11), One Direct (until September 11), PIBA (Primary Industries Bank of Australia) (until September 11), Other Banks.





**WE ENCOURAGE  
THE INQUIRY  
TO PRESERVE  
WHAT HAS  
PROVEN TO BE OF  
MOST VALUE TO  
THE ECONOMY,  
CUSTOMERS AND  
THE COMMUNITY  
AND TO PREPARE  
FOR FUTURE  
CHANGE.  
COMMBANK CAN.**

