

# **Financial System Inquiry**

## **Interim Report**

July 2014

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# Foreword

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## Background to this Inquiry

On 20 November 2013, the Treasurer, the Hon. Joe Hockey MP, released a draft terms of reference for the Financial System Inquiry (the Inquiry) for consultation with interested stakeholders.

After completing this consultation process on 20 December 2013, the Treasurer released a final terms of reference (at *Appendix 1*) and appointed a Committee, independent of Government, to undertake this task. The Committee comprises:

- Mr David Murray AO (chair)
- Professor Kevin Davis
- Mr Craig Dunn
- Ms Carolyn Hewson AO
- Dr Brian McNamee AO

The Committee is charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth.

In March 2014, the Treasurer also appointed an International Advisory Panel (the Panel) to provide an expert international perspective on issues relevant to the Inquiry. The Panel comprises: Sir Michael Hintze AM (London), Dr David Morgan AO (London), Ms Jennifer Nason (New York) and Mr Andrew Sheng (Hong Kong).

The Treasurer tasked the Committee with producing an Interim Report for consultation with stakeholders in mid-2014, before providing a Final Report in November 2014.

## Consultation

The Inquiry has taken a consultative approach to its task. Submissions for a first round of consultations, based on the Terms of Reference, opened on 30 January 2014 and closed on 31 March 2014. As part of this process, the Inquiry received over 280 submissions. *Appendix 3* provides a list of stakeholders who lodged first round submissions.

In addition, the Inquiry has participated in more than 100 meetings with interested stakeholders to gather information, seek alternative perspectives and discuss policy issues in depth. This included Committee members meeting with a large range of domestic stakeholders on a bilateral basis, including financial institutions, businesses, academics, consumer groups and regulators. The Committee also met with the Panel and international regulators.

The Committee would like to thank all stakeholders who have freely given their time to assist the Inquiry in its task so far.

This consultation process, which has gathered both policy issues and stakeholder views on market-related opportunities and challenges, has been the primary source of information in preparing this Interim Report.

Through this Interim Report, the Inquiry is now calling for a second round of submissions to gather further evidence, check the validity of observations and test potential policy options. For information on how to make a submission, please refer to [www.fsi.gov.au](http://www.fsi.gov.au).

Submissions are requested by **Tuesday, 26 August 2014**.

## Scope of Interim Report

The purpose of this Interim Report is to elicit comments from interested stakeholders to inform the Final Report to the Treasurer. The Interim Report does not make recommendations, nor does it describe the final view of the Inquiry.

Each chapter of the Interim Report makes a number of **observations** on the Australian financial system, as summarised in the Executive Summary. These observations reflect the Inquiry's current judgement, based on available evidence. The Inquiry welcomes additional evidence from interested stakeholders to either support or contest these observations.

The observations do not cover all the issues raised in submissions or consultations. By necessity, the Inquiry has had to prioritise issues. Even so, the range of topics covered

in the Interim Report remains broad. Stakeholders are encouraged to provide feedback on whether other issues are of greater priority than those covered in the Interim Report and which issues should be the focus of the Final Report.

Reflecting the observations made, the Interim Report also includes a range of possible **policy options** mentioned throughout each chapter. The Inquiry seeks evidence of the costs and benefits of these options, including the option of 'no change' or other policy alternatives. As mentioned above, these policy options are not the Inquiry's draft recommendations. In most cases, the Inquiry has chosen to put forward a spectrum of policy options, rather than a single suggested option.

In considering reforms, the Inquiry is mindful that no system is perfect and preferred outcomes will not always be practical or cost effective to achieve. The Inquiry's final recommendations will reflect the Committee's judgement, based on the evidence provided, that the change will deliver a better balance of policy outcomes than the status quo.

The Inquiry recognises other processes may be best placed to consider certain subjects in further detail, including through concurrent Inquiry processes such as the Tax White Paper and the Competition Policy Review.

The Inquiry also notes that, concurrent with the preparation of this report, the Senate has been examining the performance of the Australian Securities and Investments Commission. The Senate Committee's Report contained a large number of recommendations relevant to the work of this Inquiry. The Senate Report was issued at the time the Interim Report was being finalised for printing. The findings of the Senate Report will be carefully examined by this Inquiry in the lead-up to its Final Report.

Most chapters also include a number of specific **questions** where additional information would be appreciated to assist in preparing the Final Report and making final recommendations.

## Next steps

Following its release of the Interim Report, the Inquiry will continue to engage actively with stakeholders. In addition to receiving formal submissions, Committee members and secretariat staff will undertake a range of consultation processes, including public forums and domestic and international stakeholder meetings.

Over the remainder of the available time, the Inquiry will further focus its attention on those issues of the highest priority, gathering more evidence to make informed, practical policy recommendations to the Treasurer in November.



## Executive Summary

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### Objectives and principles

This Inquiry's objective is to assess, and make recommendations on, how the financial system can most effectively help the Australian economy be productive, grow and meet the financial needs of Australians.

To meet this objective, the Inquiry considers that the financial system must satisfy three principles: efficiently allocate resources and risks, be stable and reliable, and be fair and accessible. These three principles underpin the following analysis.

### The Inquiry's initial assessment

Based on the input of submissions, regulators and international perspectives, the Inquiry's initial assessment is that, to date, the Australian financial system has performed reasonably well in meeting the financial needs of Australians and facilitating productivity and economic growth.

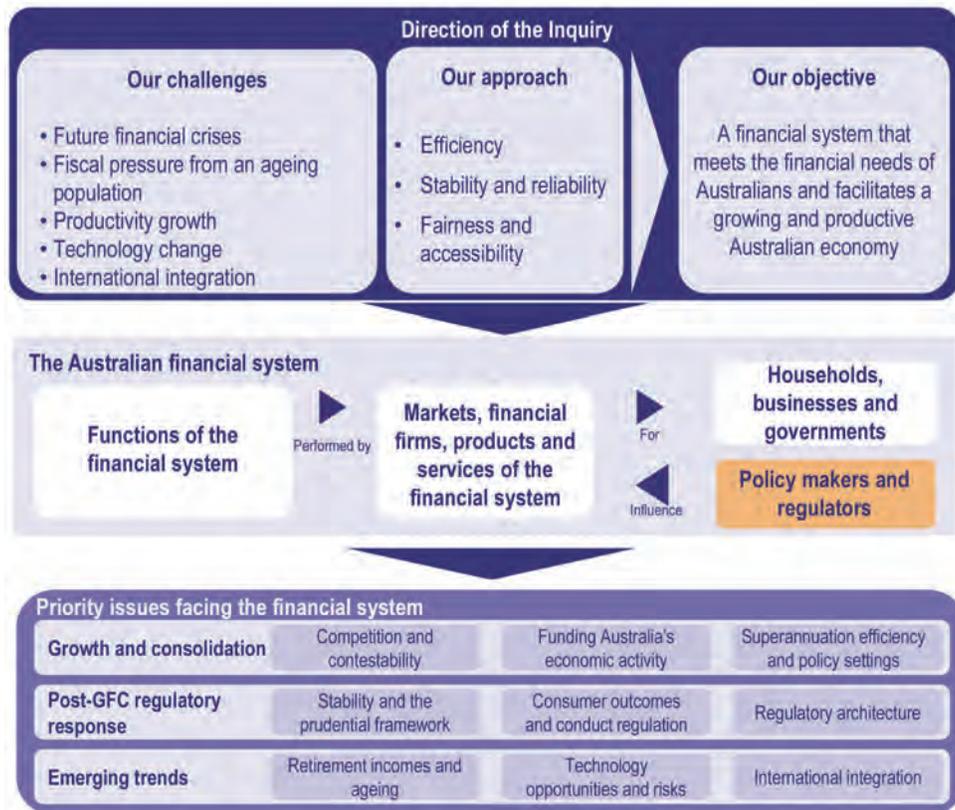
Indeed, many areas of the financial system are operating effectively and do not require substantial change. Those areas are not the focus of this Interim report.

However, there is no room for complacency. The Australian economy will face a number of opportunities and challenges in the coming decades. Each of these has implications for the financial system:

- **Future financial crises:** History has demonstrated that financial crises can and will occur at significant cost to the economy. Although we cannot predict their cause or timing, our financial system framework should reduce the likelihood and impact of such events.
- **Fiscal pressures:** The Commonwealth's fiscal position will continue to come under long-term pressure, particularly from the effect of an ageing population.
- **Productivity growth:** On its current trajectory, productivity growth will not be able to sustain the same rate of income growth experienced over the past decade. The financial system has an important role to play in facilitating higher productivity growth through funding the economy more efficiently, including funding new businesses and using new technology.

- **Technology change:** The rapid pace of technology change has already had a significant impact on both consumers’ interaction with the financial system and how the system functions. Although difficult to predict, future changes will present both opportunities and risks for the financial system and are expected to continue to have a significant impact.
- **International integration:** Although Australia’s key financial relationships remain with Europe and the United States, the weight of global economic activity is shifting towards Asia. This trend presents opportunities and risks for Australia.

In analysing how well the Australian financial system is prepared to meet these challenges, the Inquiry has identified nine **priority issues** facing the system, as outlined in the diagram below.



The Inquiry makes a number of **observations** related to each issue. These observations are based on the evidence presented to the Inquiry through the consultation and submission process as well as the Inquiry’s judgement. In most cases, these observations reflect areas where submissions suggest the performance of the system may be improved in some way.

*The Inquiry seeks additional evidence from interested stakeholders to support, or contest, these observations.*

Based on these observations, the Inquiry puts forward a range of possible **policy options** for consultation. These policy options should not be considered as draft recommendations. The Inquiry has sought to consult on a broad range of policy options to ensure informed practical policy recommendations in the Final Report.

*The Inquiry seeks evidence on the costs, benefits and trade-offs of these options from stakeholders, including the option of 'no change' or alternative options.*

The remainder of the executive summary outlines the Inquiry's observations and possible policy options for stakeholder feedback.

## Growth and consolidation

Since the Wallis Inquiry, the financial system as a whole has grown significantly, especially the superannuation sector. The system has also seen considerable consolidation and integration, particularly in banking.

Against this backdrop of growth and consolidation, and noting the consequences of the global financial crisis (GFC), the Inquiry observes several issues, including opportunities for improvement in competition and contestability, distortions in funding flows, and issues with the efficiency and policy settings of the superannuation system.

## Competition and contestability

Competition is the cornerstone of a well-functioning financial system, driving efficient outcomes for price, quality and innovation.

Most sectors of the Australian financial system are concentrated, with that concentration generally increasing since the Wallis Inquiry. Banking, payments, financial market infrastructure (FMI) and personal general insurance have a relatively high degree of market concentration. However, competition can be strong between players in a concentrated market. Indeed, market concentration can be a by-product of competition, if more efficient firms grow at the expense of their less efficient competitors.

*Observation*

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

On balance, the Inquiry considers that the banking sector is competitive. The net interest margins of the major banks are around historic lows, and their average return on equity is comparable to those achieved by other large Australian companies. However, although the banking sector as whole appears competitive, the level of competition may vary across individual banking markets.

Risk weights affect the extent to which a bank must fund its assets using regulatory capital rather than potentially cheaper deposits and wholesale debt. The IRB banks have lower risk weights for mortgage lending than standardised ADIs, although the advantage is less clear in relation to other asset classes. This provides the IRB banks with a cost advantage for mortgage lending. However, the extent of the disadvantage would vary between ADIs, depending on the riskiness of their assets, as well as over time.

Large banks derive funding advantages from their size and sophisticated risk management systems. However, some submissions argue that large banks also benefit from a funding advantage because they are perceived as being too-big-to-fail. The Inquiry considers the best way to deal with any potential competitive advantage arising from these perceptions is to directly address the systemic risks posed by large banks.

During the GFC, the residential mortgage-backed securities (RMBS) market became dislocated and the cost of RMBS funding increased. Since then, the market has started to recover, although not back to pre-GFC levels. There is little evidence that the current state of the RMBS market and the associated deterioration in the competitive position of smaller ADIs and non-bank lenders relate to an ongoing market failure.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

Regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral.

The Inquiry considers that interchange fee caps have improved the functioning of four-party payment schemes. They have reduced merchant service fees. Although difficult to measure, the caps have also most likely reduced cross-subsidisation from customers who use low-cost payment mechanisms, such as cash, to those who use high-cost payment schemes.

However, payment systems of similar economic substance should be regulated consistently. Arguably four-party interchange fees, companion card service fees and incentive payments under all schemes are equivalent in economic substance.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Lower interchange fee caps, ban interchange fees, expand interchange fee caps to include payments of similar economic substance, or remove interchange fee caps.
- Cap merchant service fees or cap differences in interchange service fees between small and large merchants.
- Require acquirers to enable merchants to choose which scheme to route transactions through, and provide merchants and customers with real time pricing information regarding interchange fees and merchant service fees.
- Allow schemes to reintroduce ‘no surcharge’ rules, broaden the ban on ‘no surcharge’ rules, or enforce reasonable cost recovery in customer surcharging.

The *Competition* chapter also seeks information on the following topics:

- Competition in small- and medium-sized enterprise (SME) and personal lending
- Vertical integration in the banking sector

### Funding Australia’s economic activity

The efficiency with which Australia’s financial system allocates funding and risk in the economy affects Australia’s economic growth and long-term living standards. Although it is difficult to assess allocative efficiency, it is likely that distortions are hampering the operation of price mechanisms that would otherwise promote an efficient allocation of funding and risk. The Inquiry has identified three main sources of distortions: taxation, regulation and market imperfections.

#### *Observation*

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

Australia has been a net importer of foreign funds for much of its history and has therefore recorded persistent current account deficits. Used productively, additional investment increases the economy’s growth potential.

*Observation*

There are structural impediments for small- and medium-sized enterprises to access finance. These impediments include information asymmetries, regulation and taxation.

Financing constraints can limit a firm's development and ability to transform ideas into technical advances. This can affect broader job creation, productivity and economic growth.

Information asymmetries are the most significant structural factor contributing to the higher cost and lower availability of credit for SMEs. Lenders typically will have limited knowledge about a new borrower's financial position, the financial performance of the business and the financial behaviour of the business owner.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

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

Traditionally, private non-financial corporations have made relatively little use of the domestic bond market. A more developed and accessible corporate bond market would provide corporates with more funding options and allow investors to better diversify their portfolios.

Corporate issuers face impediments in making public offers of listed corporate bonds, particularly to retail investors. Reducing such impediments would likely increase investor demand for domestic corporate bonds.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

The Inquiry has identified a number of tax issues that affect the allocation of funding and risk in the economy.

Certain tax and regulatory settings distort households’ saving decisions towards housing, for both owner-occupiers and investors. Tax incentives also encourage investors to use more leverage than otherwise might be the case.

Since the Wallis Inquiry, the increase in housing debt and banks’ more concentrated exposure to mortgages mean that housing has become a significant source of systemic risk.

A number of other taxes may materially affect the demand for, and supply of, funding for particular sectors and the broader allocation of funding and risk. Details of tax issues raised in the report are in *Appendix 2 (Tax Summary)*.

The *Funding* chapter also seeks information on the following topics:

- Australia’s insolvency regime
- Infrastructure financing
- Impact investment and social impact bonds
- The banking system
- Superannuation
- Equity financing

## Superannuation efficiency and policy settings

Principally as a result of Government policy, the superannuation system is large and growing rapidly. It is an important source of funding for long-term capital formation, which is important for national productivity growth.

### *Observation*

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

Notwithstanding the difficulties in comparing fees and costs across funds, Australia's superannuation sector has some of the highest operating costs among Organisation for Economic Co-operation and Development countries. The decline in fees over the past decade is modest, given the economies of scale that the sector has achieved. That said, high allocations to growth and alternative assets contribute to these costs, but they can also deliver higher after-fee returns to members.

In general, competition has led to feature-rich, but more costly, superannuation products, in part reflecting that many consumers are not fee sensitive. It is too early to assess the effect of recent reforms to default arrangements (MySuper) on fees. There is an opportunity for fees to fall significantly over time, with further expected increases in scale and increased competition for MySuper products.

High demand for liquidity from superannuation funds may be reducing after-fee returns to members. The mandatory inter-fund portability timeframe of three days is contributing to higher allocations to liquid assets than the system requires.

It remains unclear whether funds are chasing short-term returns and, if so, whether this is contributing to lower after-fee returns, as well as to what extent more individual tailoring of asset allocations would produce net benefits to members.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements and review the effectiveness of the MySuper regime in due course.
- Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.
- Replace the three-day portability rule:
  - With a longer maximum time period or a staged transfer of members’ balances between funds, including expanding the regulator’s power to extend the maximum time period to the entire industry in times of stress.
  - By moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach.

***Observation***

If allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial systems.

The general lack of leverage in the superannuation system is a major strength of the financial system. Although direct leverage in superannuation is small, the current ability to borrow directly may, over time, erode this strength and create new risks to the financial system.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

Restore the general prohibition on direct leverage in superannuation on a prospective basis.

***Observation***

Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.

Constant change in superannuation and retirement income policy settings imposes costs on superannuation funds, which are ultimately paid by members. As

superannuation is a long-term savings vehicle, change can also undermine confidence and trust in the system.

To ensure policy stability, the system needs to achieve, and be seen to achieve, its objectives efficiently and equitably, and the fiscal cost needs to be sustainable. Some evidence casts doubt over whether current policy settings will stand the test of time.

The *Superannuation* chapter also seeks information on the following topics:

- Mechanisms to drive down fees
- Vertical integration
- Tailoring asset allocation and the focus on short-term returns
- Active asset management
- Pricing of member investment switching
- Liquidity management
- Trust structure
- Self-managed superannuation fund operating costs and establishment

### Post-GFC regulatory response

The GFC tested both the resilience of the Australian financial system generally and the performance of its regulators. We can learn many lessons from the GFC. This has been reflected in the substantial volume of regulatory change over recent years in Australia and internationally.

The Inquiry considers this an opportune time to revisit Australia's approach to stability and the prudential framework, consumer and conduct regulation, and our regulatory architecture. In light of the GFC experience, the Inquiry will consider the need for any change.

### Stability and the prudential framework

Australia's approach to financial stability proved resilient during the GFC. No prudentially regulated institution experienced a disorderly failure, and there was only

a minor interruption to economic growth.<sup>1</sup> However, there are many lessons on which to reflect.

*Observation*

During the GFC, significant government actions in a number of countries, including Australia, entrenched perceptions that some institutions are too-big-to-fail. These perceptions can be reduced in Australia by making it more credible to resolve these institutions without Government support.

Financial institutions that were of such size, market importance or interconnectedness that their failure would cause significant financial or economy disruption were at the heart of the GFC. Unprecedented government support was extended to these institutions globally, which – although necessary to avoid worsening the crisis – perversely entrenched views that such institutions are too-big-to-fail and therefore receive an implicit government guarantee. Reversing these perceptions and their associated moral hazard has been a focus of the international regulatory agenda.

The Australian Government can adopt a number of measures to reduce these perceptions. It can take steps to make it more likely or more credible to achieve orderly failure without Government support and to lower the probability of failure in the first place. Some of these steps would be relatively low-cost and straight forward to implement, while others would involve substantial changes to the Australian financial system. Many of these measures could also have an effect on competition.

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<sup>1</sup> A number of non-prudentially regulated institutions did fail over this period. However, while these caused losses for individual investors, their broader effect was limited.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

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

Systemic risks have the potential to cause financial system-wide disruption and inflict severe damage on the economy, as demonstrated by the GFC. The ability to identify and manage systemic risks is critical to long-term financial stability and economic growth. In general, Australia has a robust framework for monitoring and responding to systemic risks, although risks arising outside the prudential perimeter may be more difficult to manage.

A number of international jurisdictions have introduced quantitative 'macroprudential' tools for managing systemic risk. Empirical evidence and academic research is still limited on the effectiveness of these tools. Nevertheless, the Inquiry sees merit in investigating whether some additional tools for addressing systemic risk would be helpful, but it is cautious about Australia adopting tools that are yet to be proven.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

**Observation**

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

Australia adheres to a number of international prudential frameworks, in particular the Basel framework for the banking industry. Among other benefits, this strengthens Australia's international reputation and facilitates the integration of Australia's financial system with the rest of the world. Australia is an active member of many international standard-setting bodies and has had considerable success in ensuring that such standards are fit for Australia.

As an importer of capital, it is critical that Australia continues to adopt appropriate international standards. This will require Australia's active participation in the international bodies that set these standards to ensure they suit our national circumstances.

Submissions highlight some areas where Australia has used national discretion to diverge from baseline international standards. In some instances, this divergence has obscured international comparisons of prudential ratios, potentially creating real costs for industry. However, Basel Committee on Banking Supervision data shows that Australian banks do not have excessively high capital ratios relative to their peers.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

To contribute to the effectiveness of the financial system, sound corporate governance requires clarity of the responsibilities and authority of boards and management. There are differences in the duties and requirements of governing bodies for different types of financial institutions and, within institutions, substantial regulator focus on boards has confused the delineation between the role of the board and that of management.

The GFC revealed the failure of both the boards and senior management of some international financial institutions to understand fully the risks their institutions were undertaking, as well as a culture of focusing on short-term gains. Recognition of the role boards and senior management play in fostering corporate culture and determining the risk appetite and behaviour of financial institutions is critical.

However, stakeholders are concerned that, in Australia, regulatory burdens unduly require boards to play a quasi-management role, taking time away from other appropriate governance activities and strategic oversight. Part of this may stem from a lack of clarity around regulators’ expectations of boards, which should be addressed.

In addition, the primary duty of governing bodies differs across different types of financial institutions. For example, the relevant legislation requires that insurer directors and superannuation fund trustees place the interests of policy holders and members ahead of those of shareholders, yet there is no equivalent for ADIs. It is not clear if this diversity is appropriate.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Review prudential requirements on boards to ensure they do not draw boards into operational matters.
- Regulators continue to clarify their expectations on the role of boards.

The *Stability* chapter also seeks information on the following topics:

- Financial Claims Scheme
- The appropriate primary duties of financial institution governing bodies

### Consumer outcomes and conduct regulation

The financial system should meet the financial needs of Australians. Retail consumers are an important end-user of the financial system. Trust in the financial system is an important prerequisite for consumers to participate confidently and actively in the financial system. Since the Wallis Inquiry, consumers have been increasingly required to participate in the financial system through compulsory superannuation.

Fundamental to the effective operation of the financial system is the appropriate allocation of risk between participants. Consumers, like other participants, must take responsibility for both the risk and reward of financial decisions. However, adverse consumer outcomes in the financial system may result from a variety of factors, including fraud, mis-selling, product unsuitability, lack of information and lack of financial literacy.

Consumer outcomes can be enhanced by a variety of methods, including competition, innovation by industry and effective regulatory regimes (including self-regulation). Regulation seeks to create confidence and trust in the financial system, inform consumers and assist them to manage their risk. Active surveillance and enforcement are an important part of enhancing confidence and trust in the financial system and encouraging consumer participation. Although Australia's financial system performed reasonably well during the GFC, consumers still suffered substantial loss in some areas. In addition, a series of domestic failures in the last decade have demonstrated limitations in a number of vital elements of the consumer protection framework introduced following the Wallis Inquiry.

### *Observation*

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

Although disclosure is an important part of the regulatory regime for providing financial products and services, it alone has not been sufficient to enable consumers to make informed decisions and purchase products and services that meet their needs. Over the past decade, industry and Government have made efforts to improve the quality of disclosure documents. However, a culture of legal compliance, rather than a focus on how best to inform consumers, continues to influence the design of disclosure documents. This has resulted in lengthy and complex documents, rather than short, targeted documents that highlight product features, risks and rewards. Submissions also argue that disclosure compliance has been costly for industry.

### *The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

### *Observation*

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

For consumers to engage effectively with the financial system and meet their financial needs, they need access to advice that helps them make informed financial decisions. Many consumers consider that their advice needs are currently unmet.

Studies suggest there are significant issues with the quality of financial advice, due in part to varying standards of adviser competence and the impact of conflicted remuneration structures. Some submissions suggest aligned or vertically integrated structures may also reduce the quality of advice consumers receive.

At times, consumers also lack access to affordable advice. In addition, some submissions question whether general advice is properly labelled and whether consumers understand its nature, given general advice often includes sales and advertising information.

### *The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

### *Observation*

Technological developments have the potential to reduce insurance pooling. This will reduce premiums for some consumers; however, others will face increased premiums, or be excluded from access to insurance. Underinsurance may occur for a number of reasons, including: personal choice, behavioural biases, affordability, and lack of adequate information or advice on the level of insurance needed.

Insurance can mitigate risks of significant loss for consumers. The decision to insure against certain risks is a personal one, which means there will always be a level of non-insurance and underinsurance in the system. However, other factors may also drive levels of underinsurance. The increasing trend towards risk-based pricing may make insurance more affordable for some consumers. However, it will also disadvantage others through increasing costs, potentially to the point of unaffordability, or may mean that some people are simply not offered insurance. That said, risk-based pricing provides important price signals to consumers, which may encourage risk minimisation in some cases.

The *Consumer outcomes* chapter also seeks information on the following topics:

- Financial literacy
- Financial advice
- Disclosure for prospectuses
- Levels of underinsurance
- Industry self-regulation
- Microfinance facilitating access to credit
- Small business lending
- Regulation of managed investment schemes
- Consumer loss as a result of misconduct
- Product rationalisation of legacy products

### Regulatory architecture

Australia's regulatory structure has served us well, and the perimeters defined by the Wallis Inquiry remain broadly valid. However, market developments, technological advancements and stakeholder feedback suggest there is value in re-examining certain aspects.

The Inquiry has also commissioned work on the costs and benefits of the extent of regulation in the financial system, and seeks further evidence in this regard. In parallel, the Government is running a deregulation process that includes improving policy development processes and assessing existing regulation.

The Inquiry also notes that concurrent with the preparation of this report, the Senate has been examining the performance of the Australian Securities and Investments Commission. The Senate Committee's Report contained a large number of recommendations that are relevant to the work of this Inquiry. The Senate Report was issued at the time the Interim Report was being finalised for printing. The findings of the Senate Report will be carefully examined by this Inquiry in the lead-up to its Final Report.

### *Observation*

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

The Inquiry's intention is to assess the current regulatory perimeters and align regulation for like risks. A number of areas have been examined, building on the Wallis Inquiry's intensity of promise.

### *The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

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

Strong, independent financial regulators are crucial to the efficient, stable, fair and accessible operation of the financial system. However, regulators also require robust accountability mechanisms that provide appropriate checks and balances.

Submissions identify areas of improvement in relation to operational and budgetary independence. Current funding models for the Australian Prudential Regulation Authority (APRA) and ASIC diverge from best-case funding models for financial regulators. In particular, the current funding models potentially could be improved through increasing the certainty of year-to-year funding.

Although Australian financial regulators are subject to a range of existing accountability mechanisms, the Inquiry recognises there is room to strengthen accountability mechanisms, particularly in light of proposals to increase independence.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

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

The Council of Financial Regulators (CFR) is a well-functioning mechanism, playing an important role in coordinating financial regulation and stability issues.

The CFR’s objective is to contribute to the efficiency and effectiveness of financial regulation by providing a high-level forum for cooperation and collaboration among its members. The capacity of the CFR to perform this function was tested during the GFC, to the satisfaction of both domestic stakeholders and the International Monetary Fund.

Regulators also participate in a number of councils, committees and working groups with each other, through which regulatory interventions and supervision activities are coordinated.

Underlying these coordination mechanisms is a strong culture of cooperation and collegiality among the financial sector regulators and the Treasury.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

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

An effective regulatory model requires Government to specify regulators' mandates and objectives with clarity and transparency. Although the individual parts of Australia's regulatory mandates are clear, they are not entirely unambiguous: they require judgement in balancing sometimes competing objectives. Submissions typically raise this issue in the context of competition.

Stakeholders also question the breadth of ASIC's mandate, which has grown over time.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

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

Regulators face strong competition for top talent, given the size and high remuneration levels of the Australian financial sector. Another hurdle is the perception that APRA and ASIC's operational independence and effectiveness are unduly hampered by public sector operating constraints.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

The *Regulatory architecture* chapter also seeks information on the following topics:

- Costs and benefits of regulation
- Regulator mandates, including the role and remit of ASIC

## Emerging trends

Over the coming decades, Australia will confront a number of continuing trends as well as new drivers of change for the financial system, creating both opportunities and risks. These changes include our ageing population, technological change and Australia's international integration. To varying degrees, these trends are already manifesting themselves.

### Retirement incomes and ageing

The superannuation drawdown phase of Australia's retirement income system provides limited choice for managing risk in retirement. It also gives little guidance to retirees in navigating complex and important financial decisions. Retirees do not efficiently convert superannuation benefits into income streams in retirement.

#### *Observation*

The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.

During the accumulation phase, employers make Superannuation Guarantee contributions automatically on behalf of employees, with defaults applying to those who are less engaged with the system. This framework to guide individuals ceases at retirement. Retirees make critical, once-in-a-lifetime decisions regarding when and how to draw down their savings over the remainder of their lives, and how to manage the investment, inflation and longevity risks involved. Many retirees are unprepared for these decisions.

Risk management is a major weakness of the drawdown phase. Although individuals are concerned about outliving their savings, few retirees use income stream products

with longevity risk protection, and there a limited choice of these products. Australia is unusual in not encouraging its citizens to use income streams with longevity protection in retirement. Also, the Government bears significant longevity risk by providing the Age Pension.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

A spectrum of options to achieve the objectives of the retirement income system and position Australia to manage the challenges of having an ageing population:

- Maintain the status quo with improved provision of financial advice and removal of impediments to product development.
- Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.
- Introduce a default option for how individuals take their retirement benefits.
- Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).

*Observation*

There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.

Around half of superannuation benefits in retirement are currently paid as lump sums, while the other half are paid as income streams. Australians who wish to convert their superannuation assets into a retirement income stream can essentially choose from two types of products: account-based pensions and annuities. The overwhelming majority of retirees who take income streams choose an account-based pension.

There are products that could help retirees achieve their desired levels of income and help them manage their risks better. These do not exist in Australia due to market impediments.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-tests.
- For product providers, streamline administrative arrangements for assessing the eligibility for tax concessions and Age Pension means-tests treatment of retirement income products.
- Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products.

The *Retirement income* chapter also seeks information on the following topics:

- Potential increased government provision of longevity insurance
- Reverse mortgages

### Technology opportunities and risks

Technology is a powerful force for change in the financial system, potentially improving efficiency and competition, and benefiting consumers. Consumers have better access to information and products to meet their needs. Firms can better customise products and enhance internal processes. Competition is emerging from technology-enabled alternative business models, new entrants and new services.

Financial services boundaries are shifting as firms from inside and outside the sector harness the power of data to create and capture value in new ways. In particular, many are seeking to influence a greater share of consumers' spending. Increasingly, technology firms and retail groups are also becoming part of financial service delivery. These trends and benefits bring new or intensified risks.

### *Observation*

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

Government and regulators face ongoing challenges from the need to apply existing regulatory frameworks to new participants and products. In a rapidly changing environment, a technology neutral approach facilitates regulatory flexibility. As firms outside the regulated financial sector increasingly perform financial-type functions, challenges are raised for the regulatory perimeter. Although innovation may bring risks, it is important for Government to enable technology's benefits to flow through the financial system, while also maintaining stability.

### *The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

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

Firms are collecting, storing and using growing volumes and types of customer data. Information analytics has the potential to provide consumers with better products and improved access. It may also present opportunities to empower consumers through access to better information for decision making. Firms may be able to improve internal processes, such as those for risk assessment and pricing, and create more efficient marketing and better cross-sell opportunities. Although there are many potential benefits from the growth and use of data, concerns are increasingly raised about the way in which personal information is used and handled.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- Review and assess the new privacy requirements two years after implementation to consider whether the impacts appropriately balance financial system efficiency and privacy protections.
- Review record-keeping and privacy requirements that impact on cross-border information flows and explore options for improving cross-border mutual regulatory recognition in these areas.
- Implement mandatory data breach notifications to affected individuals and the Australian Government agency with relevant responsibility under privacy laws.
- Communicate to APRA continuing industry support for a principles-based approach to setting cloud computing requirements and the need to consider the benefits of the technology as well as the risks.

*Observation*

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

The rise of e-commerce and widespread internet connectivity expose financial institutions to increasingly more cyber crime. Cyber attacks are growing in

sophistication and frequency. Cyber security is one of the Government's top national security priorities and the financial system is considered part of Australia's critical infrastructure.

Consumers' growing preferences for online and digital delivery of financial services is increasing the need for digital identity solutions. Australia currently has a decentralised identity infrastructure and various building blocks to assist with digital identity solutions. However, it has not yet developed a detailed approach for the future of digital identities.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- Review and update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation and progress public-private sector collaboration.
- Develop a national strategy for promoting trusted digital identities, in consultation with financial institutions and other stakeholders.

The *Technology* chapter also seeks information on the following topics:

- Priorities for regulatory amendments in relation to technology neutrality
- Government and regulatory mechanisms for responding to innovation
- Consumer and private sector access to data
- Cyber security information sharing, standards setting and crisis planning
- Digital identity roles and responsibilities for the private and public sector

### International integration

Australia has benefited substantially from financial integration with the rest of the world, most notably from trade and accessing international capital markets over many decades. Benefits have also flowed from opening up Australia's financial services market to foreign competition and from exporting financial services to other markets, although these exports have not been as significant.

Since the GFC, cross-border capital flows have declined globally and the international regulatory response to the crisis has in part aimed to reduce the interconnectedness of the global financial system and increase its resilience to shocks. Although the risks are real, there remain long-term benefits from financial integration.

The Inquiry supports efforts to drive greater financial integration with the rest of the world, provided it doesn't compromise appropriate standards for financial stability and conduct in Australia. The Inquiry does not support tax subsidies, concessions or market intervention to enhance financial integration.

*Observation*

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

Given the anticipated development in Asian financial markets in coming decades, and the strength and significance of Australia's trade relationships with the region, opportunities to access capital in Asia are likely to increase. Predictions are that Australian and Asian financial services firms will expand into each other's markets and grow financial services exports and imports. Ongoing engagement with financial markets in North America and Europe will also continue to be important.

The Inquiry seeks to engage with stakeholders in more detail about the existence of impediments and the priorities for considering them, prior to the Inquiry's Final Report.

*Observation*

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

Commercial issues and market conditions are often the most significant factors affecting the level and nature of financial integration; however, policy and regulatory settings are also important. These factors are especially significant in the financial services sector, both because it is heavily regulated and because, since the GFC, more standards are being set by international bodies and foreign regulation increasingly extends to activities occurring in Australia.

Mutual recognition by regulators facilitates greater integration, as do arrangements between central banks.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*Observation*

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

Although greater financial integration is not without risk, a number of inquiries have made recommendations to remove impediments to greater integration and foster mutual recognition, particularly within the Asian region. Government has generally responded positively to these recommendations, but implementation has been slow and not always well coordinated across Government, regulators and industry.

The Inquiry recognises that much of the success in enhancing financial integration will depend on commercial and market factors, as well as the financial sector's willingness and capacity to drive greater integration.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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



# 1: Overview

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## Objectives and principles

This Inquiry's objective is to assess, and make recommendations on, how the financial system can most effectively help the Australian economy be productive, grow and meet the financial needs of Australians.

The financial system provides funding and liquidity, allows effective risk management, delivers payment services, facilitates price discovery and provides some monitoring services. Although tested during the global financial crisis (GFC), Australia's financial system performed well in most respects relative to its international counterparts.

However, the Inquiry considers there are policy issues that need close examination given developments since the Wallis Inquiry and the lessons of the GFC, as well as the opportunities and challenges that lie ahead.

## The view of the Inquiry

The Inquiry considers the financial system needs to satisfy three principles: efficiently allocate resources and risks, be stable and reliable, and be fair and accessible.

It must do so in the context of Australia's circumstances. Australia is a small, open and market-based economy with a large services sector, a relatively small population, a large land mass and a significant endowment of natural resources. It uses both domestic and foreign investment to fund development. The financial system is predominantly privately owned and based on market principles that support risk taking and allow both success and failure.

A number of pre-requisites underpin a well-functioning financial system, including a predictable rule of law with strong property rights (providing certainty of contract and access to redress), a freely convertible floating currency, sustainable fiscal policy, a sound monetary policy framework and a stable political system. The Inquiry believes independent monetary policy, prudential supervision and conduct regulation remain the preferred approach over direct Government control of prices and quantities in the financial system.

Competition remains the cornerstone of a well-functioning financial system. It is vital in driving efficient outcomes for price, efficiency, quality and innovation.

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However, the behaviour of financial markets and the financial system is complex, reflecting the consequences of information asymmetries, network effects and human psychology.

Asset prices are prone to volatility, which can be exacerbated by the natural momentum of markets and/or the intervention of governments. This can result in asset values deviating from fundamental values and instability, particularly with the use of leverage. The GFC entrenched perceptions that some institutions are too-big-to-fail. Governments have a role in both preventing the build-up of systemic risk and creating a framework in which financial failure is managed in an orderly and cost-effective manner.

Consumers of financial products and services can be subject to information imbalances and behavioural biases that are detrimental to them and the efficiency of the system. Effective disclosure, sound advice and improved financial literacy are necessary, but often incomplete, remedies to these information imbalances. In addition, conduct and disclosure requirements need to be effectively supervised and enforced.

Wherever possible, the financial system should be subject and responsive to market forces. It should not be politicised to the extent that the Government sets prices, or mandates non-commercial financial decisions to resolve Government fiscal problems such as requiring banks to hold Government debt. Market discipline, through competition or self-regulation, is generally preferred to Government intervention.

Where there is compelling evidence for Government intervention, the Inquiry considers the intervention should seek to best balance efficiency, stability and fairness. Inevitably, policy decisions facing the Government require some trade-offs.

The system has evolved in response to consumer needs, competitive pressures, tax settings, demographic changes, new technology, and ongoing change to global economic and financial developments.

The Inquiry is aware that the legal and governance obligations of financial entities, such as fiduciary duties, can be a driving force in determining the culture of Australian businesses, their decision making and financial outcomes for Australians.

It is also the Inquiry's view that financial system regulators need sufficient powers, independence and resourcing, but they should also be subject to rigorous accountability mechanisms. Regulation should be cost-effective, transparent, targeted, forward-looking and competitively and technological neutral. Ultimately, however, governments and ministers remain responsible and accountable for the regulation of the financial system.

## Principles for government intervention<sup>1</sup>

The Inquiry has not seen evidence to suggest a need to reform radically the way Government intervenes in or regulates the financial system. However, as noted in the terms of reference, the current framework is in need of a refresh to enable the system to meet future challenges.

The Wallis Inquiry's approach to regulatory philosophy broadly considered unfettered financial markets would generally lead to resources being allocated efficiently. In the Wallis Inquiry's view, the role of Government was only to intervene where market imperfections inhibited efficiency.<sup>2</sup>

The financial system has undergone significant change since the Wallis Inquiry. It is now larger and more concentrated, particularly the banking and superannuation sectors. The GFC demonstrated that the Australian financial system was exposed not only to domestic but international shocks. Since the Wallis Inquiry it has also become clearer that financial market outcomes can sometimes depart markedly from outcomes suggested by the theoretical ideal. Over the coming decades, the financial system will also face a number of challenges and opportunities. These include: exposure to potential future crises; allocating finance to best facilitate productivity growth; the effects of changing technology and ongoing international integration.

Figure 1.1 shows selected major events affecting the financial system since the Wallis Inquiry, and local and international governments' responses to these events.

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1 Intervention can occur through regulation, tax, the social safety net, guarantees or other specific policies such as superannuation.

2 Commonwealth of Australia 1997, *Financial System Inquiry Final Report*, Melbourne, First key finding of Chapter 5 – Philosophy of Financial Regulation.

**Figure 1.1: Selected major developments since the Wallis Inquiry**

		DEVELOPMENT	RESPONSE
<p><b>Growth and consolidation</b></p> <p><i>Since the Wallis Inquiry, assets of financial institutions, including banking and superannuation, and household wealth have all grown significantly.</i></p> <p><i>The financial system has become more concentrated and integrated.</i></p>	March 1997	Wallis financial system inquiry report	'Twin peaks' regulatory model introduced.
	2000-04		Financial Services Reform process. Introduction of licensing and regulatory regime for financial services providers, financial product disclosure, and authorisation for exchanges and clearing and settlement facilities.
	March 2001	HIH Insurance collapse	Government intervention to protect customers. Royal Commission called. Tort law reforms introduced. Culture of prudential regulator changed to be more proactive.
	September 2001	United States 9/11 terrorist attacks	Anti-money laundering and introduction of Government-owned terrorism insurer.
	2001-02	Enron, WorldCom, Arthur Andersen corporate collapses in the United States	Led to enhanced corporate governance in the United States (Sarbanes-Oxley Act) and reform of international accounting and auditing standards.
<p><b>Post-GFC regulatory response</b></p> <p><i>The global financial crisis resulted in dislocation of credit markets, heightened volatility, and collapses of large financial institutions in some overseas locations.</i></p>	July 2008		COAG agreement on nationalised credit code. Resulted in introduction of nationally consistent credit regulation for lenders, including new responsible lending obligations.
	September 2008	<b>Global financial crisis</b>	Monetary and fiscal policy easing, Government introduction of wholesale and retail deposit guarantee, temporary restrictions on short selling and driver of global banking, insurance and regulatory reform, including Basel III, liquidity requirements, Dodd-Frank Act, and over-the-counter (OTC) derivatives.
	2009	Investment failures, including Storm Financial, Trio, Opes Prime	Catalyst for Future of Financial Advice reforms.
	July 2010		Release of Super System Review into superannuation. Resulted in the Stronger Super reforms, including the launch of the MySuper simple default product.
	January 2011	Natural disasters (including Queensland floods)	Changes to insurance products and consumer disclosure regulation.
<p><b>Emerging trends</b></p> <p><i>In the context of low productivity growth and fiscal challenges, these include our ageing population, new technology and ongoing international integration.</i></p>	2011-13	European sovereign debt crisis	European Union fiscal support for member states, austerity measures taken in Europe, record low official interest rates.
	Ongoing		Ongoing international regulatory reform agenda, including continuing implementation of Basel III and liquidity requirements, domestic systemically important banks requirements, shadow banking regulation and OTC derivatives reform.

The Inquiry acknowledges the Government has a role in the financial system, but considers it important that this intervention is consistent and predictable. Consistency of approach reduces opportunities for preferential treatment, encourages predictability and reduces risks associated with economic decisions by the private sector.

Although advances in network theory, understanding of the consequences of imperfect information and behavioural economics are useful developments that assist in better understanding the behaviour of the financial system, no widely accepted philosophy of optimal government intervention has emerged from this research.

### A refreshed approach

In the first instance, the Inquiry takes the view that the status quo is the appropriate starting point for policy discussion. This is not to suggest the financial system as it currently operates is perfect; rather, policy makers should focus on how the current system can be improved from its current state.

This approach acknowledges there are realities in the Australian and international financial system that dictate or influence certain outcomes and should not or cannot easily be changed. For example, as an open market economy using foreign savings, Australia must accept key aspects of internationally driven financial regulation, while adapting it appropriately to meet national conditions wherever possible. The Inquiry has also noted the importance of ethics, incentives and governance arrangements, and the influence these factors can have on financial system outcomes.

Like the Wallis Inquiry, this Inquiry considers there remains a role for Government to intervene to remove impediments to the market working more efficiently, including intervention to manage information asymmetries<sup>3</sup> and principal-agent conflicts.<sup>4</sup>

In addition to efficiency, the Inquiry believes both stability and fairness should have prominence in policy design when the Government considers intervention in the financial system. Importantly, these characteristics build confidence and trust in the financial system.

- The potential costs of instability to the economy during the GFC underlined the need for Government action to both minimise the chance of a systemic crisis and mitigate its costs if it does occur. This includes ensuring that certain critical financial functions continue to be provided, even during a crisis.
- Moreover, fairness is an important policy objective of the financial system. Unfair outcomes discourage participation and ultimately economic efficiency, increasing political pressure for unnecessary regulatory change. Fairness is also a principle underpinning several aspects of financial system law, including regulation of financial markets and services.

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3 Information asymmetry or information imbalance occurs when the two parties entering into a transaction do not have the same level of information.

4 Principal-agent conflicts occur if an agent (for example, a company executive) pursues their own self-interest rather than those of the principal (for example, a shareholder) who has provided them resources and delegated responsibility for making decisions.

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Fairness involves fair treatment by applying the concepts of integrity, honesty, transparency and non-discrimination (entities with the same characteristics are treated in the same manner) which go to building trust in the financial system.

Of course, these policy objectives can be conflicting and add complexity to policy decisions. Some of the most difficult policy decisions facing the Government occur where there is a trade-off between these objectives, including many of those discussed in this report. Where intervention is necessary, the Inquiry considers it should not unduly add to the complexity of regulatory arrangements.

There is no simple empirical calculation that provides the answer on when or how the Government should intervene (or remove a previous intervention) in the financial system. Case-by-case judgement is required, and both the costs and benefits of a policy change should always be carefully considered.

The Inquiry emphasises the importance of market forces and competition in any cost-benefit analysis. The financial system has the ability to evolve successfully in response to market signals without Government intervention in many situations. In many cases, the best outcome may be for the Government to allow market forces to operate. The removal of unnecessary Government regulation and interventions that do not meet this cost-benefit test should remain a priority where they are identified.

The Inquiry suggests the following principles (Table 1.1) to guide the actions of Government and regulators. Although sometimes conflicting, the Inquiry considers Government and regulators should take account of these principles when regulating or considering regulation for the financial system.

**Table 1.1: General principles of government intervention**

<b>Outcome-focused</b>	Regulation and actions by regulators should reflect the outcomes sought by policy. This is not to suggest regulation should be simple or complex – but appropriate for the policy outcome desired.
<b>Forward-looking</b>	The regulatory framework must have the flexibility to cope with changing institutional and product structures, including in response to regulatory settings, without losing its effectiveness.
<b>Cost-effective</b>	Regulation should impose the least possible aggregate cost to the regulated business, its customers and the regulator, while still achieving the desired outcome. The costs of regulation should be allocated to those that enjoy the benefits or impose the costs.
<b>Competitively/technologically neutral</b>	The regulatory framework affects all entities providing products or services with the same characteristics equally, regardless of technological approach.
<b>Targeted and proportionate</b>	Ideally, regulation should only constrain the behaviour of those who will otherwise act inappropriately or make decisions without taking into account social costs. Regulation should be targeted to minimise adverse effects on those entities for which it is not needed and be as simple as possible to achieve the policy outcome desired.
<b>System-wide approach</b>	A system-wide view of the interdependence, interconnectivity and feedback relationships between different parts of the financial system and other sectors of the economy, including internationally, is required. Very often the externalities, overlaps and gaps, hidden connections and dynamic feedbacks create risks and distortions to efficiency that are not recognised by either markets or siloed regulators
<b>Transparent</b>	The actions and purpose of Government (or regulators) should be obvious to participants in the financial system, both before and after the event. The actions of Government or regulators should also be consistent and predictable.
<b>Accountable/independent</b>	Regulators should have clear mandates determining their objectives. In achieving these objectives, regulators should operate independently and have sufficient funding. Regulators must be held to a high level of accountability for their actions and be subject to regular public reviews of their performance relative to their mandate.

## Themes and major issues

Taking into account the input of submissions, regulators and international perspectives, the Inquiry's initial assessment is that the Australian financial system has performed reasonably well in meeting the financial needs of Australians and facilitating productivity and economic growth.

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Indeed, many areas of the financial system are operating effectively and do not require substantial change. This Inquiry has not focused on these areas.<sup>5</sup>

However, a number of policy issues have been raised that the Inquiry believes should be considered further. The remainder of this chapter provides context for why the Inquiry has chosen to concentrate on the issues covered in this Interim report.

Table 1.2 outlines the Inquiry's view of the nine priority issues facing the Australian financial system and its key observations. It is followed by an explanation of the evidence supporting each issue. The following chapters of the Interim Report address each of these issues in more detail, including presenting potential policy options.

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5 For the purposes of this Inquiry, the Committee considers private health insurance to be out of scope. Private health insurance is closely linked to the operation of the health system and government plays a significant role in approving products and premiums. In addition, it does not pose a systemic risk to the financial system.

**Table 1.2: Priority issues**

Theme one: Growth and consolidation	
<b>Competition and contestability</b>	The banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral.
	Regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral.
<b>Funding Australia's economic activity</b>	Ongoing access to foreign funding has enabled Australia to sustain higher growth than otherwise would have been the case. The risks associated with Australia's use of foreign funding can be mitigated by having a prudent supervisory and regulatory regime and sound public sector finances.
	There are structural impediments for small- and medium-sized enterprises to access finance. These impediments include information asymmetries, regulation and taxation.
	Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development.
<b>Superannuation efficiency and policy settings</b>	There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system.
	If allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial systems.
	Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.
Theme two: Post-GFC regulatory response	
<b>Stability and the prudential framework</b>	During the GFC, significant government actions in a number of countries, including Australia, entrenched perceptions that some institutions are too-big-to-fail. These perceptions can be reduced in Australia by making it more credible to resolve these institutions without Government support.
	A number of jurisdictions have implemented new macroprudential toolkits to assist with managing systemic risks. The effectiveness of these for a country like Australia is not yet well established and there are significant practical difficulties in using such tools.
	Australia has implemented some aspects of global prudential frameworks earlier than a number of jurisdictions. It has also used national discretion in defining capital ratios. When combined with other aspects of the prudential framework and calculated on a consistent basis, Australian banks' capital ratios (common equity tier 1) are around the middle of the range relative to other countries. However, differences such as those in definitions of capital do limit international comparability.
	To contribute to the effectiveness of the financial system, sound corporate governance requires clarity of the responsibility and authority of boards and management. There are differences in the duties and requirements of governing bodies for different types of financial institutions and, within institutions, substantial regulator focus on boards has confused the delineation between the role of the board and that of management.

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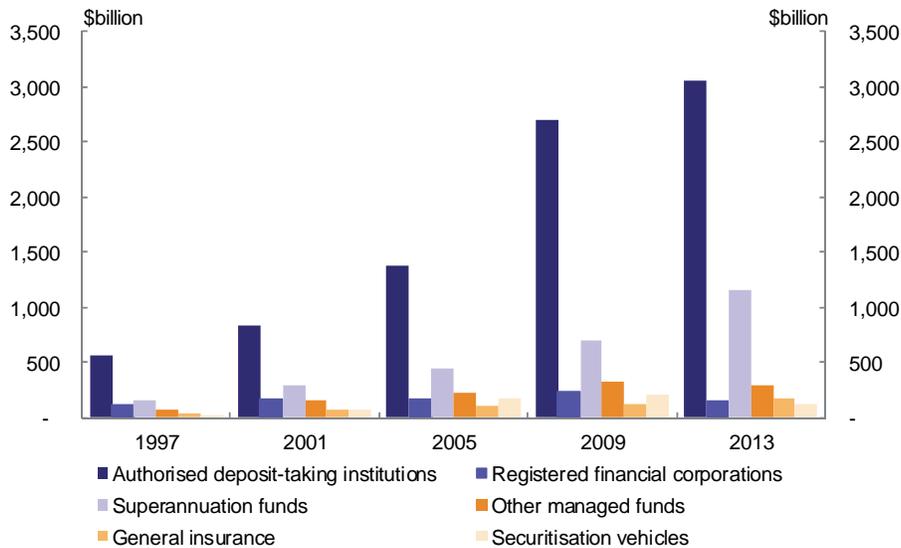
<b>Consumer outcomes and conduct regulation</b>	The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.
	Affordable, quality financial advice can bring significant benefits for consumers. Improving the standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower-cost scaled advice.
<b>Regulatory architecture</b>	The regulatory perimeters could be re-examined in a number of areas to ensure each is targeted appropriately and can capture emerging risks.
	Australia generally has strong, well-regarded regulators, but some areas for improvement have been identified to increase independence and accountability.
	During the GFC and beyond, Australia’s regulatory coordination mechanisms have been strong, although there may be room to enhance transparency.
	Regulators’ mandates and powers are generally well defined and clear; however, more could be done to emphasise competition matters. In addition, the Australian Securities and Investments Commission (ASIC) has a broad mandate, and the civil and administrative penalties available to it are comparatively low in relation to comparable peers internationally.
<b>Theme three: Emerging trends</b>	
<b>Ageing and retirement incomes</b>	The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.
	There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.
<b>Technology opportunities and risks</b>	Technological innovation is a major driver of efficiency in the financial system and can benefit consumers. Government and regulators need to balance these benefits against the risks, as they seek to manage the flexibility of regulatory frameworks and the regulatory perimeter. Government is also well-positioned to facilitate innovation through coordinated action, regulatory flexibility and forward-looking mechanisms.
	Access to growing amounts of customer information and new ways of using it have the potential to improve efficiency and competition, and present opportunities to empower consumers. However, evidence indicates these trends heighten privacy and data security risks.
	The financial system’s shift to an increasingly online environment heightens cyber security risks and the need to improve digital identity solutions. Government has the ability to facilitate industry coordination and innovation in these areas.
<b>International integration</b>	Although elements of Australia’s financial system are internationally integrated, a number of potential impediments have been identified. Financial system developments in the region will require continuing Government engagement to facilitate integration with Asia.
	Government efforts to promote Australia’s policy interests on international standard setting bodies have been successful. Domestic regulatory processes could be improved to better consider international standards and foreign regulation.
	Coordination of Australia’s international financial integration could be improved.

## Growth and consolidation

Two of the most striking developments in the financial system since the Wallis Inquiry have been the growth and consolidation of the financial system.

- Financial system assets have grown from the equivalent of two years of nominal GDP in 1997 to more than three years of nominal GDP today.<sup>6</sup> In particular, superannuation assets have grown substantially (Chart 1.1). Australia’s financial sector accounts for 8 per cent of GDP and is relatively large internationally.<sup>7,8</sup> However, the focus of this Inquiry is not the size of the financial system but how effectively it distributes funding and risk in the Australian economy.
- The Australian financial system has become more concentrated and integrated since the Wallis Inquiry. In particular, each of the four major banks has expanded its operations into life insurance and wealth management. These developments have prompted concerns about competition in the market.

**Chart 1.1: Assets of financial institutions**



Note: Refers only to domestic operations and does not include assets of banks’ overseas subsidiaries and branches. Registered financial corporations include money market corporations (for example, merchant banks) and finance companies (for example, debenture issuers).  
 Source: Reserve Bank of Australia.<sup>9</sup>

6 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 15.  
 7 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 17.  
 8 Australian Bureau of Statistics (ABS) 2013, *National system of accounts 2012/13*, cat. no. 5204.0, ABS, Canberra. Note: Uses gross value added at basic prices (total industrial value added).  
 9 Reserve Bank of Australia (RBA) 2014, *B1 Assets of financial institutions*, RBA, Sydney, 2 June.

## Competition and contestability

Competition is important because of its ability to lower prices and improve quality of financial products, services and markets.

High levels of market concentration can raise concerns about the level of competition in a market, but it is not sufficient to look at this measure alone. Competition can be strong between players in a concentrated market. In addition, the threat of new entrants can exert competitive pressures on incumbents.

### *Competition in banking*

Australia's banking market has become more concentrated since the GFC, with declines in the share of credit provided by credit unions, building societies and the non-bank sector. The crisis drove concentration by pushing out smaller lenders as the cost of funding rose, which reflected the higher price of risk following the GFC.

Australia's larger banks have a number of commercial competitive advantages over their smaller domestic rivals, including scale of operations, funding costs, product breadth and brand recognition. On balance, the Inquiry considers that the banking sector is competitive, reflecting a number of indicators. Australian banks' net interest margins have almost halved since the early 1990s<sup>10</sup> and the Reserve Bank of Australia (RBA) submits that returns on equity are comparable to those achieved by other large Australian companies.<sup>11</sup>

The Inquiry notes existing capital requirements are not always competitively neutral. Larger banks have satisfied the criteria to use an advanced approach when implementing the Basel II capital requirements, but smaller authorised deposit-taking institutions (ADIs) have to charge more to achieve the same return on equity for a mortgage.<sup>12</sup> Some submissions hold the view that, particularly for their mortgage book, smaller banks would have lower capital requirements if they were able to employ internal ratings-based approach (IRB) models.

Some submissions argue that the larger banks also benefit from a funding advantage from being perceived as too-big-to-fail. However, it is the Inquiry's view that the best way to deal with any competitive advantage arising from these perceptions is to address directly the systemic risks posed by large banks.

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10 Treasury 2014, First round submission to the Financial System Inquiry, page 34.

11 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 165.

12 Australian Prudential Regulation Authority 2014, First round submission to the Financial System Inquiry, page 75.

Funding is critical to ADI and non-bank lenders' ability to compete. The use of residential mortgage-backed securities (RMBS) was a key factor in growing the market shares of smaller banks and non-bank lenders before the GFC. The crisis significantly increased the cost of this type of funding, thereby reducing the competitive position of smaller ADIs and non-bank lenders. Although the RMBS market has started to recover, the relative cost of fund raising via this method remains higher than before the GFC.

The 'four pillars' policy, which prevents mergers between the big four banks, has been in place, with some modifications, since 1990. Allowing a merger between the large banks would likely reduce competition, and this may offset any advantages that flow from larger scale. No submissions supported removing this policy.

### *Competition in payment systems and markets*

The payments industry is characterised by significant economies of scale and strong network effects, with the challenge for new payment system operators to build scale through acceptance by consumers and merchants.

A lack of transparency has required regulatory intervention to provide consumers and merchants with clearer price signals and more choice in responding to them. Without regulation, customers who use lower-cost payment methods, such as cash, may cross-subsidise those who use other forms of payments.

Some submissions argue that, while the regulated caps on credit card interchange fees may have reduced costs for merchants and customers at the checkout, they have also lowered the value to cardholders by limiting reward points and potentially making credit card fees or interest rates higher than they would have been.

There are separate standards or access regimes for eftpos, scheme debit cards, scheme credit cards and automated teller machines (ATMs). Due to this, some payment system operators are subject to relatively intensive regulation, while others are less heavily regulated. Several submissions ask for more consistency in the way different schemes are regulated.

### *Funding Australia's economic activity*

As discussed above, the Australian financial system has grown substantially. However, the Inquiry recognises that a larger financial system is not necessarily beneficial to economic growth and a system that is too large may pose greater risks to economic growth.<sup>13</sup> The Inquiry is focusing on the efficiency with which Australia's

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<sup>13</sup> For a discussion of this issue, see for example Cecchetti, S and Kharroubi, E 2012 *Reassessing the impact of finance on growth* Bank for International Settlements Working Paper No 381, BIS, Basel.

financial system allocates funding and risk in the economy, rather than on its size or direct contribution to economic activity.

Australia has been a user of foreign funding for much of its post-European settlement history. It has typically had more abundant domestic investment opportunities than could be funded from historic levels of national saving. By using these foreign funds productively, Australia's growth potential has been raised, benefiting both residents and foreign investors.

The continued inflow of foreign funding reflects the confidence foreigners have in Australia's growth prospects. Although Australia's use of foreign funding is not without risks, these can be mitigated by ensuring these funds are directed to their most productive use, as well as maintaining a prudent regulatory regime and a sustainable fiscal position. Based on evidence presented in submissions, the Inquiry notes some distortions that may interfere with the allocative role that prices perform.

In particular, the Inquiry identifies distortions affecting household financial decision making and structural impediments to small- to medium-sized enterprise (SME) lending. It also recognises the effects of the taxation system on outcomes in the financial system.

### *Housing and household leverage*

Taxation distorts households' saving and borrowing decisions towards housing and salary-sacrificed superannuation, and encourages higher levels of household leverage to fund purchases of dwellings.

Since the Wallis Inquiry, household leverage has almost doubled.<sup>14</sup> This has been accompanied by a significant increase in housing prices relative to income over the past decade.<sup>15</sup> Higher household indebtedness and the greater proportion of mortgages on bank balance sheets mean that an extreme event in the housing market would have significant implications for financial stability and economic growth.

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14 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 22 (ABS, APRA and RBA data). Note: since 1997, household leverage has increased from debt equivalent to around 0.8 years of gross disposable income to around 1.5 years of income in 2008 – household leverage has since stabilised at around this level. Disposable income is after the payment of tax and before the deduction of interest payments.

15 Reserve Bank of Australia (RBA) 2014, *Home Prices and Household Spending research discussion paper 2013-14*, RBA, Sydney.

### *SME financing*

Australia's 2 million SMEs employ almost 70 per cent of the workforce.<sup>16</sup> SMEs and new ventures source some of their business equity from their own personal wealth; however, they also require external sources of finance. The Inquiry notes that, compared to their larger counterparts, the price and terms of SME loans can be more restrictive. For example, many lenders now require more security, usually residential property, for business loans.<sup>17</sup> In large part, this is due to the lack of information lenders have on the financial behaviour of SMEs and their owners.

### *Other taxation issues*

As Australia becomes increasingly integrated with global capital markets, there is also a question of whether the corporate tax regime, particularly the dividend imputation system, is effective in reducing the cost of capital in Australia. The dividend imputation system creates a bias for individuals and institutional investors (including superannuation funds) to invest in domestic equities, and it may be a contributing factor to the lack of a deep domestic corporate bond market in Australia.

Interest withholding tax (IWT) may also be distorting the funding decisions of financial institutions and placing Australia at a competitive disadvantage internationally. A number of submissions call for IWT to be removed or reduced.

The Goods and Services Tax (GST) is not levied on most financial services. This affects the size of the financial services industry relative to other industries where GST is levied, and affects the composition of the end-users who ultimately consume those financial services. However, levying a GST on financial services is difficult.

A more neutral taxation of savings vehicles and assets across the economy is desirable. It is not this Inquiry's role to make recommendations on tax issues; however, the Inquiry will provide its observations to the Government's forthcoming Tax White Paper.

### *Superannuation efficiency and policy settings*

A major development since the Wallis Inquiry is the rapid expansion in superannuation assets. Superannuation assets have grown from around \$300 billion to \$1.8 trillion today.<sup>18, 19</sup> Continued high rates of growth are expected for the foreseeable

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16 Australian Bureau of Statistics (ABS) 2013, *Counts of Australian businesses, including entries and exits Jun 2009 – Jun 2013*, cat. no. 8165.0, ABS, Canberra.

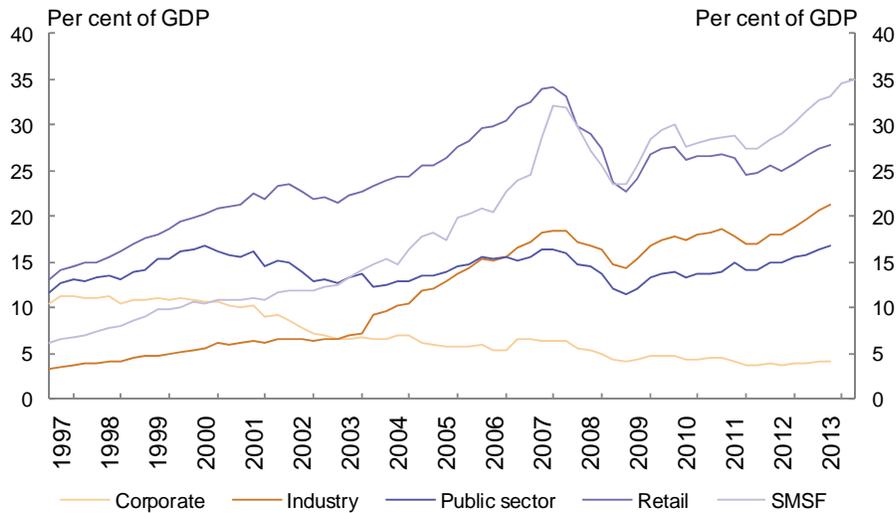
17 Reserve Bank of Australia 2011, *Submission to the Inquiry into Access of Small Business to Finance*. Cited in Export Finance and Insurance Corporation 2014, First round submission to the Financial System Inquiry, page 5.

18 Australian Prudential Regulation Authority (APRA) 2007, *Insight: Celebrating 10 years of superannuation data collection 1996-2006*, Issue 2, Special Ed., APRA, Sydney.

future and will be driven by the increase in the Superannuation Guarantee rate to 12 per cent by 2022, superannuation tax concessions, and investment returns. Industry Super Australia predicts that superannuation assets will exceed those of the banking system by around 2030.<sup>20</sup>

The structure of the system has also changed significantly. The number of Australian Prudential Regulation Authority (APRA)-regulated funds (excluding small APRA funds) has fallen from more than 4,700 to 299 since 1997,<sup>21</sup> and the number of self-managed superannuation funds (SMSFs) has grown rapidly. SMSFs now make up the largest segment of the superannuation system in terms of the number of entities and the size of funds under management (Chart 1.2).<sup>22</sup>

**Chart 1.2: Superannuation assets by fund type, percentage of GDP**



Note: Excludes the balances of funds of life offices; the assets of small APRA funds are negligible. Industry and public sector series break in September 2003 due to coverage changes; public sector excludes some exempt schemes. Corporate reclassification of superannuation entities and data revisions resulted in material changes for corporate funds from 2004.  
 Source: Reserve Bank of Australia.<sup>23</sup>

19 Australian Prudential Regulation Authority 2014, *Statistics: Quarterly superannuation performance (interim edition)*, Sydney, March.  
 20 Industry Super Australia 2014, First round submission to Financial System Inquiry, page 117.  
 21 Australian Prudential Regulation Authority (APRA) 2007, *Insight: Celebrating 10 years of superannuation data collection 1996-2006*, issue 2, Special Ed., APRA, Sydney; Australian Prudential Regulation Authority 2014, *Statistics: Quarterly superannuation performance (interim edition)*, APRA, Sydney, March.  
 22 Australian Prudential Regulatory Authority (APRA) 2014, *Statistics: Quarterly superannuation performance (interim edition)*, APRA, Sydney, March.  
 23 Reserve Bank of Australia 2014, data supplied to Financial System Inquiry from APRA, ATO and RBA, 13 June 2014.

The Australian superannuation system has become an important source of funding for the rest of the economy, particularly for long-term fixed capital formation. However, some evidence raises questions about the efficiency of the sector. Australian superannuation fund operating costs are among the highest in the Organisation for Economic Co-operation and Development (OECD).<sup>24</sup> The Grattan Institute estimates that fees have consumed over one-quarter of returns since 2004, despite increases in scale.<sup>25</sup> Direct leverage in superannuation funds is embryonic but growing. The number of SMSFs using geared products grew by more than 11 per cent to 38,000 over the year to April 2014.<sup>26</sup> A number of submissions point to the stabilising influence of the superannuation sector during the GFC. The current ability of funds to borrow directly may, over time, erode the superannuation system's ability to act as a stabilising influence on the financial system during times of stress.

## Post-GFC regulatory response

In the years since the Wallis Inquiry there have been several international financial crises and major institution collapses, including the Long-term Capital Management collapse, Asian financial crisis, Enron and WorldCom collapses, Russian and Argentine currency crises and dot-com crash, and then the global financial and European sovereign debt crises.

However, the GFC has had a lasting effect on Australia's financial system. After a period of favourable economic conditions in the major economies, investors worldwide began to take more risks than was prudent.

The catalyst for the crisis was the deterioration of the United States housing and mortgage market, which caused a liquidity and confidence crisis in the financial markets of developed countries. The contagion was transmitted via the interconnectedness of global financial institutions and markets, including through the growth of complex securitisation structures. A number of financial institutions in the United States and Europe collapsed. In response, governments became involved in stabilising their financial systems through guarantees, direct equity measures, and large fiscal and monetary stimulus measures.

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24 Reserve Bank of Australia, First round submission to the Financial System Inquiry, page 178 (OECD data).

25 Minife, J 2014, *Super sting: How to stop Australians paying too much for superannuation*, Grattan Institute, Melbourne.

26 Investment Trends 2014, *SMSF Investor Report*, April. Note: Based on a survey of 2,163 SMSF trustees.

Although Australia's financial system performed reasonably well through that period of acute stress,<sup>27</sup> the Government intervened in the form of wholesale and deposit guarantees, and provided support for the securitisation market. Deposit guarantees and direct support for markets departed from the Wallis Inquiry principle that the Government should not provide guarantees in the financial system.

### Regulatory responses

In response to the GFC, Australian regulators and the Government have taken steps to increase the resilience of the financial system. International bodies responsible for making standards on financial regulation have also become increasingly active. Within the G20, for example, governments and regulators in Europe and the United States have led efforts to strengthen regulation and oversight – including taking a more active regulator role in identifying and addressing the build-up of systemic risks.

An issue for Australia is the extent to which it should implement new global standards. A significant consideration for Australian authorities has been the need for our banks to maintain the confidence of external investors and credit rating agencies, given their exposure to foreign funding markets.

Australian regulators have sought to influence the design of the global framework to take into account Australia's circumstances. Further, regulators have applied the framework in a manner and timeframe to best suit Australian market circumstances, as a capital importer within a global market.

### Stability and the prudential framework

Australia has had a relatively stable financial system for most of the past two decades. In particular, Australia's financial system weathered the GFC relatively well. This stability is the result of a number of factors, including a stable macroeconomic environment; prudent risk management by financial institutions themselves; and a traditional, comparatively low-risk commercial banking model remaining profitable.

A factor contributing to Australia's resilience during the GFC was its strong prudential framework. Australia's prudential rules, often tighter than minimum international standards before the GFC, together with a proactive approach to supervision, helped maintain a healthy and stable financial sector domestically.<sup>28</sup>

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<sup>27</sup> Davis K 2011, 'The Australian Financial System in the 2000s: Dodging the Bullet', in Gerard, H and Kearns, J (eds), *The Australian Economy in the 2000s, Proceedings of a Conference*, Reserve Bank of Australia, Sydney, pages 301–48.

<sup>28</sup> International Monetary Fund (IMF) 2011, *Australia 2011 Article IV Consultation, IMF country Report No 11/300*, IMF, Washington DC.

International financial history indicates that financial crises and financial instability are not uncommon.<sup>29</sup> Instability has substantial costs to the economy. It limits the financial system's capacity to allocate funds, facilitate payments, transfer risk and create liquidity. Instability can result in losses for savers or policyholders, lower economic growth, and damage to the financial sector's ability to serve the economy. As shown by the GFC, it can also have severe negative effects on the economy, including low growth and high unemployment, and can result in policy options that lead to higher Government debt.

Internationally, governments' responses to the GFC sought to minimise these costs. These actions were often appropriate, and illustrated the potential need for government intervention in the financial system in very extreme circumstances. The GFC, both here and overseas, highlighted the link between governments and the financial sector. It demonstrated that fiscal responsibility is an important ingredient to maintaining a resilient financial system.

However, any expectation that government will support a failing financial institution creates a moral hazard in the longer term. This may reduce market discipline and encourage riskier behaviour. Although the perception that some institutions are too-big-to-fail cannot be eliminated entirely, there is much the Government can do to minimise moral hazard and the problems associated these perceptions.

As markets continue to develop, financial and technological innovations are emerging rapidly, which may bring new risks. The GFC highlighted that focusing on the soundness of individual institutions without stepping back to consider the overall financial system is not sufficient to ensure financial stability. Australia has a well-established system for monitoring systemic risk. However, risks outside the prudential perimeter can be more difficult to identify due to limited oversight and a lack of data.

To help address these risks, significant reforms such as improving the transparency of over-the-counter (OTC) derivatives have been introduced since the GFC. However, this has also moved derivatives from banks into the shadow banking sector. Globally, the increasing use of shadow banking has the potential to generate systemic risks. However, because of the small size of the shadow banking sector in Australia, risks to stability in Australia remain limited.

### Consumer outcomes and conduct regulation

Although there were no significant prudentially regulated institution failures during the GFC in Australia, the crisis resulted in significant losses for some individuals.

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<sup>29</sup> Although noting the extent to which this is an inherent feature of financial markets or the result of government interventions (or a mixture of both) remains a matter of debate.

Fraud, mis-selling, product unsuitability, lack of information and lack of financial literacy were all factors in poor financial outcomes for some Australians.

Since the crisis, the emerging theory of behavioural economics has recognised that most individuals do not always act in an economically rational way. Behavioural biases can reduce the effectiveness of many traditional consumer protection approaches, which rely on the assumption that consumers will seek out and understand all relevant information before purchasing a financial product.

### *Consumer disclosure*

Australia's regulatory framework relies heavily on disclosure to protect and empower consumers.

Submissions support a view that the disclosure framework is not achieving its objectives. The current disclosure regime produces complex and lengthy documents that do not always enhance consumers' understanding of financial products and services, and impose significant costs on industry participants.

Reasons that disclosure does not always inform consumers include low levels of financial literacy, disengagement due to lack of time or motivation, behavioural biases, and the length and complexity of disclosure documents. This situation makes it difficult for consumers to compare products, understand risks and make informed decisions.

### *Financial advice*

Retail investment failures following the GFC, including high-profile cases such as Storm and Trio, highlighted concerns with financial advice regulation.

Recent reforms have sought to improve the quality of financial advice and increase trust and confidence in the financial advice industry by introducing a best interests duty and a requirement to put the interests of the client ahead of those of the adviser. These reforms have provided greater clarity over the expectations and requirements of financial advisers. Reforms on conflicted remuneration have also sought to better align the interests of financial advisers and consumers.<sup>30</sup> The Inquiry considers the principle of consumers being able to access advice that helps them meet their financial needs is undermined by the existence of conflicted remuneration structures in financial advice.

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<sup>30</sup> Note: the Government has recently announced some changes to the Future of Financial Advice (FOFA) laws, see Cormann, M (Minister for Finance) 2014, The Way Forward on Financial Advice Laws, media release, 20 June, Canberra, viewed 2 July 2014, <<http://www.financeminister.gov.au/media/2014/0620-the-way-forward-on-financial-advice-laws.html>>

Financial advisers provide advice on a range of products including investment, debt management, tax management, superannuation and insurance. The total number of financial advisers in Australia is around 54,000, with 3,000 organisations holding an Australian Financial Services Licence to provide personal financial product advice.<sup>31</sup> However, less than 42 per cent of the Australian adult population has ever used a financial adviser.<sup>32</sup> Good financial advice is increasingly important given growing household wealth and mandated superannuation investment.

Evidence suggests that the quality of financial advice could be improved significantly. For example, ASIC's shadow shopping study of retirement advice concluded:

- More than a third of the advice examples were poor in quality (39 per cent)
- There were only two examples of good quality advice (3 per cent)
- The majority of advice examples reviewed (58 per cent) were adequate<sup>33</sup>

### Regulatory architecture

The GFC tested regulatory arrangements globally and domestically, and Australia's twin peaks model has proven robust and effective. A number of overseas jurisdictions have looked to Australia's model, or versions of it, to address weaknesses the GFC exposed in their financial systems.

Evidence suggests there is no case to make significant changes to Australia's regulatory framework.

However, submissions and stakeholders suggest a wide range of refinements. Reflecting this, the Inquiry observes a number of issues relating to regulatory architecture:

- **Regulatory burden:** Following the GFC, the considerable international policy response included new and increased regulation for financial system entities. A number of submissions are concerned about the burden of implementing new regulations. The Inquiry has commissioned further analysis of the costs and benefits of regulation, including the relative impact of the fixed cost of regulation on institutions of varying size.

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31 Australian Securities and Investments Commission 2014, First round submission to the Financial System Inquiry, page 202. Note: these are not exact numbers as there is currently no register of advisers.

32 Roy Morgan Research 2012, data provided to Financial System Inquiry, 18 June 2014.

33 Australian Securities and Investments Commission (ASIC) 2012, *Report 279 Shadow shopping study of retirement advice (REP 279)*, ASIC, Sydney.

- **Regulatory perimeters:** As the financial system environment changes, the way Australia considers the regulatory perimeter may need to change. In this context, regulation should be examined pertaining to superannuation funds, retail payments systems, securities dealers and certain technology service providers of sufficient scale.
- **Independence and accountability:** Australia generally has strong, well-regarded regulators, but some areas of possible improvement have been identified to increase independence and accountability.
- **Regulator structure and coordination:** The GFC demonstrated the importance of strong regulatory coordination mechanisms. Submissions were strongly supportive of the Council of Financial Regulators, endorsing it as the right body for high-level coordination. Some submissions recommended expanding and strengthening its role, although regulators consider it effective.
- **Execution of mandates:** Australia's regulators have mandates that place a similar emphasis on competition to international peers; however, more could be done beyond mandates to emphasise competition. ASIC's mandate is broad, having grown considerably over the last two decades, generally in response to major reform processes and reviews.
- **Enforcement powers:** Strong enforcement powers underpin an effective regulatory framework. Enforcement sends a message of deterrence to industry and is an important aspect of the consumer regulatory framework.

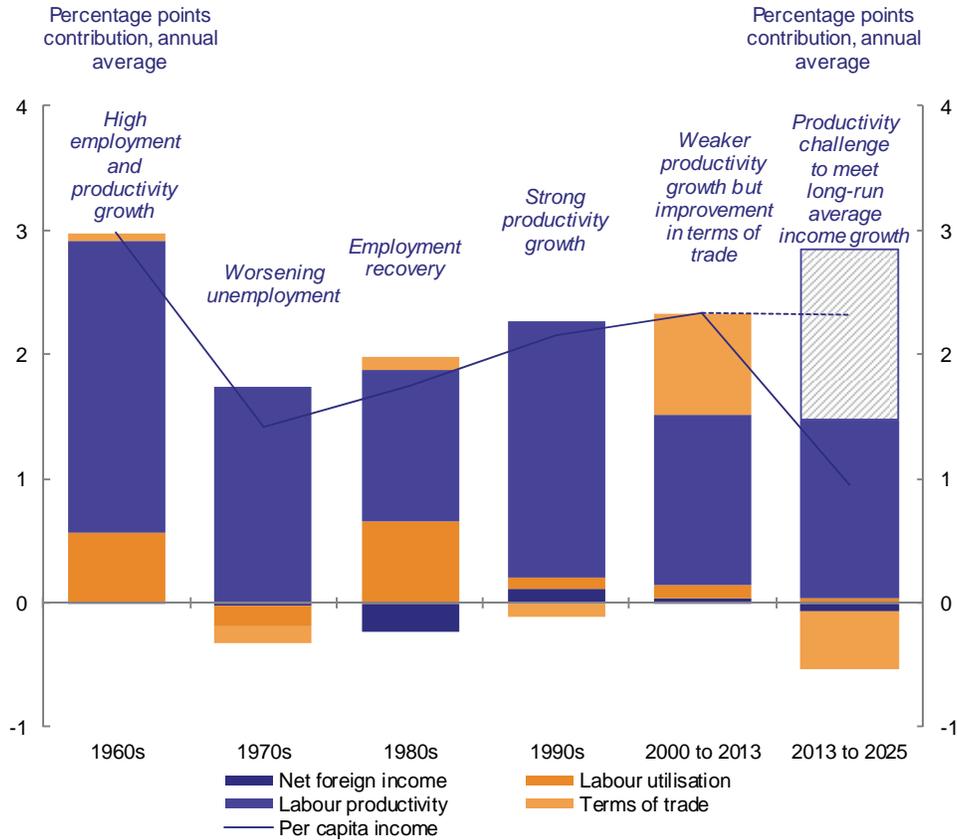
## Emerging trends

The financial system must continue to be flexible and to adapt quickly to whatever developments unfold in the future. Although the Inquiry does not intend to try and predict the future, it recognises that the financial system can play an important role in helping the economy respond to several opportunities and challenges. With the need to lift low productivity growth and ease fiscal pressures, these challenges are likely to include our ageing population, changes in technology and Australia's international integration.

The need for higher rates of productivity growth to ensure continuing improvement in living standards is a major challenge facing Australia, in particular given the need to support an ageing population.

The unprecedented increase in the terms of trade, which drove the improvement in living standards over the past decade, is believed to have ended and the terms of trade are expected to decline over coming years. On its current trajectory, productivity growth will not be able to sustain the same rate of growth in incomes that Australia has experienced over the past decade (see Chart 1.3 below).

**Chart 1.3: Contributions to annual per capita income growth**



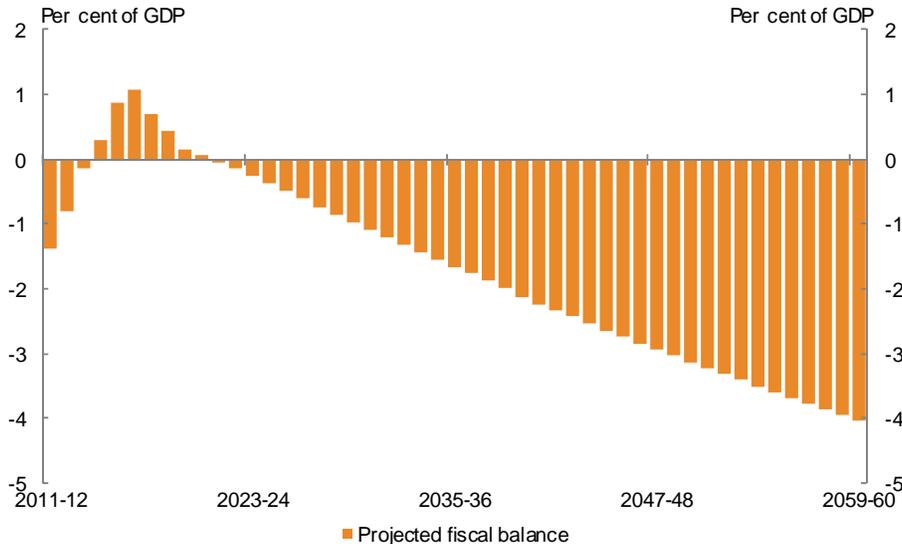
Note: Contributions to income growth in the period 2013-25 are consistent with the forecasts and projections detailed in the 2014-15 Budget Statement. The shaded grey area represents the additional labour productivity growth required to achieve long-run average growth in real gross national income per capita. Net foreign income is the differential between incomes payable to Australians by foreigners and incomes payable to foreigners by Australians, in real terms.  
Sources: Australian Bureau of Statistics and Treasury.<sup>34</sup>

The financial system has an important role to play in facilitating higher productivity growth through allocating funding in the economy more efficiently. Closer financial and economic ties with other jurisdictions can also improve productivity by allowing foreign firms to enter Australia and by supporting more competition and innovation. The financial system also enables Australian firms, both financial and non-financial, to expand offshore.

<sup>34</sup> Australian Bureau of Statistics (ABS) 2011, *Australian system of national accounts*, cat. no. 5204.0, ABS, Canberra; and Treasury.

Associated with these expected developments, the Commonwealth and state governments face a fiscal challenge. The ageing population is expected to contribute to a deterioration of the Government’s fiscal position. By 2050, these demographic developments are expected to result in a net cost to Government of 3 per cent of GDP (see Chart 1.4 below).

**Chart 1.4: Net fiscal cost of ageing to Government 2011-12 to 2059-60, as percentage of GDP**



Note: The fiscal cost is defined as the primary balance, which is the difference between Government revenues and expenditures in any given year excluding interest payments on debt.  
 Source: Productivity Commission.<sup>35</sup>

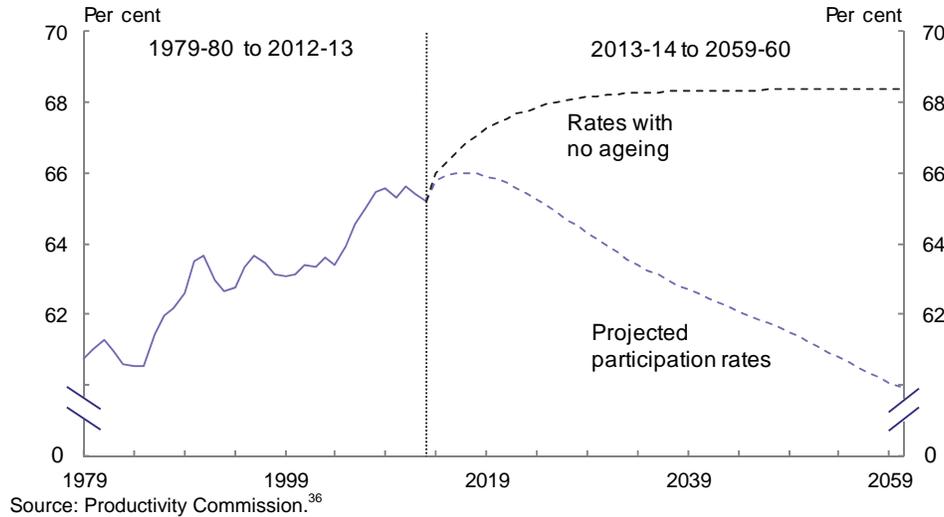
The financial system can help, or hinder, governments in relieving some of this fiscal pressure. For example, an appropriately designed retirement income system can assist in reducing the fiscal costs of the ageing population by providing products to deliver retirement incomes from superannuation balances. Conversely, policies that subsidise or incentivise imprudent or excessive risk taking may lead to adverse long-term consequences for the economy and further pressure on government spending.

### Retirement incomes and ageing

Australia faces a significant demographic challenge. The ageing population and higher life expectancy are likely to result in lower workforce participation rates (Chart 1.5), which could lower the long-run growth in the economy and may result in higher costs for governments.

<sup>35</sup> Productivity Commission (PC) 2013, *An ageing Australia: Preparing for the future*, Commission Research Paper, PC, Canberra, page 165.

Chart 1.5: Labour force participation rates



But the ageing population also presents an opportunity for the financial system. Individuals require a different set of financial products and services to enable them to manage their income and risks in retirement.

The current retirement income system provides limited choice for managing risks in retirement. The system lacks a sufficient range of financial products to help provide retirees with income and flexibility and to manage risks, particularly longevity risk.

Furthermore, current policy settings and the incentives they generate do not support product development. Australia is unusual compared to its peers in not having a well-functioning market for products that manage longevity risk. Australia's annuity market is much smaller than that of comparable countries when measured as a proportion of GDP.<sup>37</sup>

The structure of retirement income products may also affect the allocation of funding in the economy and productivity growth. As the stock of superannuation assets in the retirement phase increases, demand for defensive assets such as fixed income products can be expected to increase.

<sup>36</sup> Productivity Commission (PC) 2013, *An ageing Australia: Preparing for the future*, Commission Research Paper, PC, Canberra, page 92.

<sup>37</sup> Organisation for Economic Co-operation and Development (OECD) 2013, 'Survey of Annuity Products and their Guarantees', paper presented at the *Insurance and Private Pensions Committee* meeting, 5-6 December. Note: the OECD defines size as the amount of assets backing products (where dedicated or separated accounts back the products) or technical provisions or reserves.

## Technology opportunities and risks

Technology-driven innovation is a major driver of efficiency in the financial system and can benefit consumers. It is changing the financial products and services available to consumers, as well as the delivery channels and providers of the products and services.

Financial services boundaries are shifting as technology enables new competitors from inside and outside the sector, new business models and new services. Trends, such as the increasing adoption of cloud technology and financial institutions using growing amounts of data, provide opportunities for increasing financial system efficiency.

Australians are showing themselves to be rapid adopters of technology with 7.5 million Australians accessing the internet via their mobile phones in 2013, an increase of 33 per cent from 2012.<sup>38</sup> More Australians shop online for insurance and financial services than their counterparts in the United States and major European economies.<sup>39</sup> This has contributed to the swift growth of services such as mobile banking and electronic payments.

Although there are many benefits, technological innovation also poses challenges for Government and regulators, in particular, how to trade off potential benefits against risks. To facilitate innovation, Government and regulators should seek to be flexible in regulatory approach and technology neutral in regulation. This is not always the case currently; for example, some Federal and state-based legislation and regulations require (implicitly or explicitly) the use of certain forms of technology.

Increasing collection of data by financial institutions raises privacy-related risks. Submissions highlighted issues including that data might be used in ways a customer might not like and might reveal information about persons other than the consenting customer, such as their friends, family or clients. Other submissions note that some segments of the community, such as senior Australians, are particularly sensitive to privacy, safety and security issues.

Cyber attacks are no longer only a potential threat; they are occurring on an increasingly frequent basis. For example, in 2013 cyber crime affected 5 million Australians at an estimated cost of \$1.06 billion.<sup>40</sup> As well as these direct costs, cyber crime may erode consumer and business trust and confidence in the financial system. The financial system's shift to an increasingly online environment also heightens the

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38 Australian Communications and Media Authority (ACMA) 2013, *Communications report 2012–13*, ACMA, Melbourne.

39 The Boston Consulting Group (BCG) 2013, *2013 Global Consumer Sentiment Survey*, BCG, Boston.

40 Symantec 2013, 2013 Norton Report: Total Cost of Cybercrime in Australia amounts to AU\$1.06 billion, media release, 16 October, Sydney.

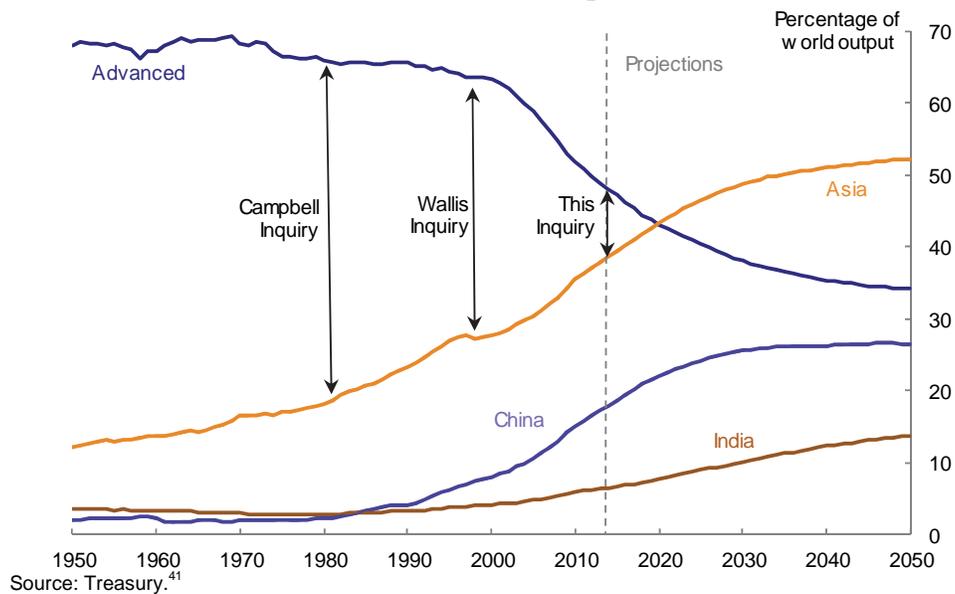
need to improve digital identity solutions. Trusted digital identities are important in helping prevent identity-related crime and fraud.

### International integration

Changes are also occurring in global financial and capital flows that are affecting the interaction of Australia’s financial system with the rest of the world. Since the GFC, cross-border capital flows have declined globally, and the international regulatory response to the crisis has in part aimed to reduce the interconnectedness of the global financial system and increase its resilience to shocks. Although the risks of connectedness with economies experiencing volatility are real, there remain long-term benefits from financial integration.

The pattern of international financial and capital flows will continue to change with forecast financial development and economic growth in the region (see Chart 1.6).

**Chart 1.6: Share of world output over time**

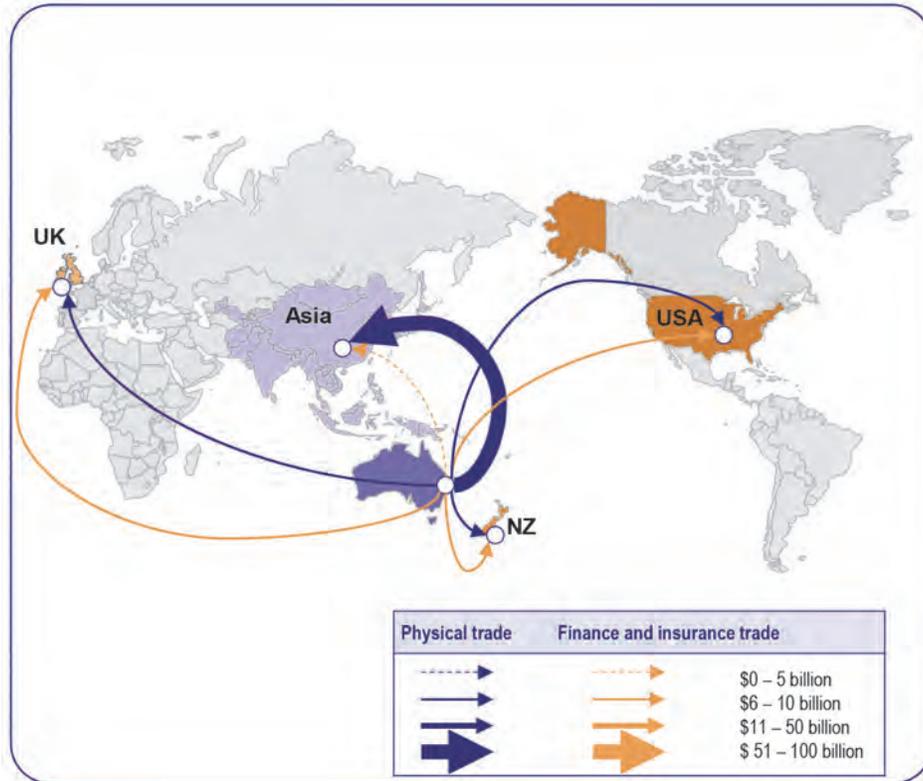


A particularly significant change is the planned gradual liberalisation of foreign exchange and capital controls for major economies in this region. Currently, Australia’s trade flows and overseas commercial presences in financial services are North Atlantic-focused, whereas physical flows are Asia-focused. (See Figure 1.2.) In

41 Based on IMF and Conference Board data, as well as Maddison, A 2010, *Statistics on world population, GDP and GDP per capita, 1-2008 AD*, Historical Statistics, Groningen Growth and Development Centre, viewed 21 June 2014, <<http://www.ggdc.net>>. Based on purchasing power parity adjusted GDP.

future, trade flows, capital raising and investment by economies in our region are likely to increase, in addition to activity in our traditional European or North American financial corridors.

**Figure 1.2: Financial and physical outward flows**



Note: Includes Australian exports of financial and insurance services, as well as financial and insurance services provided by Australia's foreign affiliates abroad.  
 Source: Australian Bureau of Statistics.<sup>42</sup>

Australia has benefited substantially from financial integration with the rest of the world, most notably from trade and accessing international capital markets over many decades. Benefits have also flowed from opening up Australia's financial services market to foreign competition and from exporting financial services to other markets, although these exports have not been as significant.

42 Australian Bureau of Statistics (ABS) 2010, *Australian Outward Finance and Insurance Foreign Affiliate Trade, 2009-10*, cat. no. 5485.0 and *International Trade in Goods and Services, Australia, 2009-10*, cat. no. 5368.0, ABS, Canberra. Asia includes China, Hong Kong, Singapore, Japan, Indonesia and Thailand

However, the Inquiry observes potential impediments to further international integration. Previous Government inquiries and private sector reviews have identified tax settings that are interfering with international flows, and regulatory and other impediments. To address impediments and effectively respond to changes in the region, coordination across Government, regulators and industry could be improved.

In addition, the Australian financial system is increasingly affected by international standards and foreign regulation. Submissions have raised concerns that domestic regulatory processes need to better accommodate the scale and complexity of increasing international influence on the regulatory environment.



## Growth and Consolidation

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Since the Wallis Inquiry the financial system as a whole has grown significantly, especially the superannuation sector. The system has also seen considerable consolidation and integration, particularly in banking.

Against this backdrop of growth and consolidation, and noting the consequences of the global financial crisis, the Inquiry observes several issues, including: opportunities for improvement in competition and contestability, distortions in funding flows, and issues with the efficiency and policy settings of the superannuation system.

<b>2: Competition</b>	<b>2-3</b>
<b>3: Funding</b>	<b>2-43</b>
<b>4: Superannuation</b>	<b>2-95</b>



## 2: Competition

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Competition is the cornerstone of a well-functioning financial system, driving efficient outcomes for price, quality and innovation.

Most sectors of the Australian financial system are concentrated, with that concentration generally increasing since the Wallis Inquiry. Banking, payments, financial market infrastructure (FMI), platform providers in wealth management and personal general insurance have a relatively high degree of market concentration. However, competition can still be strong between players in a concentrated market. Indeed, market concentration can be a by-product of competition, if more efficient firms grow at the expense of their less efficient competitors.

The Inquiry has made the following observations about competition in the Australian financial system:

- The banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral. Banks that use internal ratings-based (IRB) risk weights have lower risk weights for mortgage lending than smaller authorised deposit-taking institutions (ADIs) that use standardised risk weights, giving the IRB banks a cost advantage.
- Regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral.

### Context

This chapter examines competition across key sectors of the financial system, including banking, payments, financial markets, wealth management and insurance.

Competition is a process of rivalry between individuals or firms in the sale and purchase of goods and services. It is the cornerstone of a well-functioning financial system, driving efficient outcomes for price, quality and innovation. Competition is desirable because it generally leads to better consumer outcomes.

### Assessing competition and contestability

As competition is a dynamic process, rather than an outcome, it is difficult to measure and must be assessed indirectly using a range of indicators. These include market

concentration, barriers to entry, margins, profitability, operating costs, switching behaviour, firm behaviour and customer satisfaction.

High levels of market concentration can raise concerns about the level of competition in a market, but it is not sufficient to look at this issue alone. Competition can be strong between players in a concentrated market. Indeed, market concentration can be a by-product of competition, if more efficient firms grow at the expense of their less efficient competitors. In addition, the threat of new entrants can exert price discipline over an incumbent, even in the absence of existing competitors. This threat of competition is called 'contestability'.

As with other industry sectors, incumbent firms in the financial system have significant advantages over new market entrants. These advantages include brand recognition, existing customer bases and established distribution arrangements. Large incumbent firms have additional advantages in sectors where scale or network effects are important, such as payments or FMI, in which case new entrants will find it difficult and expensive to attract customers away from existing providers.

## Trends affecting competition

Government policy should take into account how potential future trends in markets may affect the level of competition over time. Competition issues today may resolve themselves over time, while highly competitive markets today may become less competitive. The Inquiry must consider how potential future trends may affect the level of competition over the medium to long term.

Over the medium term, technology will increasingly affect the level of competition in the financial system. In some ways, technology is improving competition. It enables consumers to compare and switch between products, making new business models, such as online-only banks and peer-to-peer lenders, viable.

However, technology also has the potential to reduce competition. Technology is introducing new economies of scale into financial markets. For example, the use of data is becoming increasingly important in understanding risks and meeting consumer needs, giving players with large customer bases the capacity to develop competitive advantages by leveraging their pre-existing data sets. Although these developments should make the financial system more efficient, they could potentially lead to less competition in the medium to long term.

## How does the Government promote competition?

Governments facilitate the operation of markets by upholding property rights and the rule of law. They also intervene in markets to promote competition, particularly where there is market failure, where firms have accrued excess market power or where there

are regulatory distortions in the market. The Government seeks to promote competition in the financial system in several ways:

- **Preventing firms from building up excessive market power and/or abusing market power.** The financial sector is covered by the competition provisions of the *Competition and Consumer Act 2010*. The Australian Competition and Consumer Commission (ACCC) is responsible for determining whether proposed mergers and acquisitions in the financial sector would substantially lessen competition. It is also responsible for enforcing provisions relating to the misuse of market power; third-line forcing; and other exclusionary conduct, cartel conduct and price signalling. The Payments System Board (PSB), which has responsibility for setting the payments policy of the Reserve Bank of Australia (RBA), plays a unique role in regulating access regimes and fee arrangements for payment schemes.
- **Promoting competition by increasing a market's contestability.** The Government can do this by reducing regulatory barriers to entry, such as licensing or authorisation requirements, or by reducing barriers to consumer switching, such as by introducing mandatory disclosure requirements or abolishing exit fees.

There is a potential trade-off between competition and stability. One of the objectives of prudential regulation is to ensure that market participants do not take inappropriate risks when competing for greater market share. Maintaining sustainable firms may also promote long-term competition.

The Government can also affect competition by imposing compliance costs on market participants. The regulatory frameworks administered by the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA), and the Australian Transaction Reports and Analysis Centre (AUSTRAC) affect the cost bases of market participants. Many submissions highlight aspects of regulation they claim are harming competition by increasing the costs of particular businesses. For example, although large institutions face the biggest absolute costs, smaller competitors may face a higher relative burden.

### The Inquiry's principles for competition policy

To facilitate competition, the Government should:

- Ensure market participants do not act anti-competitively or build up excessive market power through mergers and acquisitions
- Remove regulatory impediments to competition, such as barriers to entry and distortions to level playing fields, subject to trade-offs with other policy objectives that the regulation seeks to achieve
- In the case of network goods and natural monopolies, ensure market participants have access to infrastructure and data that enable them to compete for consumers,

subject to considerations around the investments that initial market participants may have made in developing the infrastructure or data sets

- Facilitate consumers' capacity to understand and compare products, and ensure that consumers are able to switch between products at a reasonable cost and through a simple process

## Banking sector

Australia's banking market is relatively concentrated by international standards. The share of banking assets owned by the four largest banks in Australia is higher than equivalent shares in most other jurisdictions.<sup>1</sup> Concentration has increased since the global financial crisis (GFC), with the major banks' share of total ADI assets increasing from 65.4 per cent in September 2007 to 78.5 per cent in March 2014.<sup>2</sup> However, it is not unusual for concentration to increase following a financial crisis or economic downturn.

The banking sector's increased concentration reflects two primary factors:

- Westpac and the Commonwealth Bank acquired St George and Bankwest, which together accounted for 11 per cent of mortgages and small- and medium-sized enterprise (SME) loans at the time of their acquisition.<sup>3,4</sup>
- Since the GFC, the major banks have benefited from better access to funds and lower funding costs than their competitors, allowing them to grow faster.

Some submissions, particularly those from smaller ADIs and non-bank lenders, propose that increased concentration has led to less competition. They point to the robust returns on equity earned by the major banks as an indicator of excessive profitability. However, the major banks argue there is adequate competition, pointing to low net interest margins and returns on equity around international norms.

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- 1 International Monetary Fund (IMF) 2012, 'Australia: Addressing Systemic Risk through Higher Loss Absorbency – Technical Note', *IMF Country Report no. 12/311*, IMF, Washington DC, page 7.
  - 2 Australian Prudential Regulation Authority (APRA) 2014, *Quarterly Authorised Deposit-taking Institution Performance Statistics*, APRA, Sydney, March 2014. Note: this statistic captures all assets held by ADIs, not only assets associated with borrowing and lending.
  - 3 Australian Competition and Consumer Commission (ACCC) 2008, *Public Competition Assessment: Commonwealth Bank of Australia – proposed acquisition of Bankwest and St Andrew's Australia*, ACCC, 10 December.
  - 4 Australian Competition and Consumer Commission (ACCC) 2008, *Public Competition Assessment: Westpac Banking Corporation – proposed acquisition of St George Bank Limited*, ACCC, 13 August.

On balance, the Inquiry considers the banking sector is competitive, reflecting a number of indicators.

**Net interest margins** of the major banks are around historic lows and mid-range by world standards.<sup>5, 6</sup> In the lead-up to the GFC (2004–08), the average return on equity of the major banks was around 16 per cent, and has since averaged about 14 per cent.<sup>7</sup> The RBA notes that these rates are comparable to those achieved by other large Australian companies, as well as by major foreign banks before the GFC.<sup>8</sup>

**Customer satisfaction** with the major banks has steadily increased since 2001 and is now at record highs, following an initial drop after the Wallis Inquiry.<sup>9</sup> Consumers also have access to an extensive range of products and providers. For example, there are more than 500 standard variable mortgage products from more than 100 providers available, and more than 1,500 term deposit products from over 80 providers. That said, there are only about 35 small business loan products from around 20 providers.<sup>10</sup>

Further, **bank lending fee income, non-deposit fee income and deposit fee income** as a percentage of assets have all fallen since 2000.<sup>11</sup> Fees paid by households have declined in absolute terms since 2010, with that decline largely driven by decreases in account servicing fees and transaction fees. However, fee income from businesses has increased, mainly due to an increase in account servicing fees and the volume of loans. Merchant service fees have also increased, although these have grown by only 13 per cent since 2003; whereas the value of transactions accepted has more than doubled.

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5 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry.

6 World Bank 2013, *Financial Development and Structure Dataset*, World Bank, Washington DC, November.

7 Australian Prudential Regulation Authority (APRA) 2014, *Quarterly Authorised Deposit-taking Institution Performance Statistics*, APRA, Sydney, March 2014. Note: this return on equity statistic includes returns on all ADI activities, not only borrowing and lending.

8 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry.

9 Roy Morgan Research 2014, *State of the Nation: Report 18*, April.

10 Based on review of Canstar website on 20 June 2014, <<http://www.canstar.com.au>>.

11 Craig, A 2014, *Banking Fees in Australia*, Reserve Bank of Australia, Sydney.

Although the Inquiry considers the banking sector is competitive, the level of competition may vary across individual banking markets. Stakeholders raise a number of potential competition issues that warrant consideration, including:

- The effect of regulatory capital requirements, and in particular capital risk weights, on competition
- The effect of funding costs on the competitiveness of smaller ADIs and non-bank lenders
- The level of competition in small business and personal lending
- Constraints on the ability of consumers to compare and switch between products
- The four pillars policy
- Increasing market power and vertical integration

## Regulatory capital requirements

Capital requirements are largely determined as a proportion of ADIs' risk-weighted assets. Risk weights affect the extent to which a bank must fund its assets using regulatory capital (equity, preferred shares and subordinated debt), rather than potentially cheaper deposits and wholesale debt. The purpose of risk weights is to ensure the size of an ADI's regulatory capital buffers reflects certain risks to which the ADI is exposed.

The Basel Committee on Banking Supervision (BCBS) sets minimum capital standards for banks. APRA enforces these minimum standards in Australia. The first of the Basel accords, known as Basel I, established standardised asset risk weights for calculating capital requirements, which applied to all ADIs in Australia. The Basel II framework allowed banks to seek regulatory approval to determine risk weights using IRB models that reflect their actual loss experiences. IRB modelling incentivises ADIs to improve their risk management practices by requiring less regulatory capital for lower-risk assets.

The four major banks and Macquarie Bank have had their internal risk models accredited by APRA. Other ADIs are not accredited, mainly because of the current standing of their risk management systems and the costs involved in developing internal models. Instead, they rely on standardised risk weights.

## Preliminary assessment

### *Observation*

The banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral. Banks that use IRB risk weights have lower risk weights for mortgage lending than smaller ADIs that use standardised risk weights, giving the IRB banks a cost advantage.

The IRB banks have lower risk weights for mortgage lending than standardised ADIs, although the advantage is less clear in relation to other asset classes. This provides the IRB banks with a cost advantage for mortgage lending. In its submission, APRA notes:<sup>12</sup>

- In early 2014, the average risk weight for housing lending under the IRB approach was 18 per cent, as compared to 39 per cent under the standardised approach.
- All else being equal, an ADI using the standardised approach would have to charge 23 basis points more than an IRB bank to achieve the same return on equity for a mortgage.

Submissions from smaller ADIs identify these higher risk weights as a competitive disadvantage. They argue that similar loans should be risk weighted the same, regardless of who holds them. However, APRA's submission makes the following points:

- IRB and standardised risk weights cover credit, market and operational risk. IRB banks are subject to additional requirements for interest rate risk in the banking book, whereas standardised ADIs are not. This means that direct comparisons between IRB and standardised risk weights overstate any competitive advantage for IRB banks.
- The risk weights of the IRB banks vary over time in line with their loss performance. In recent years, the IRB banks have benefited from strong asset quality and low impairments. However, this could change if they experience higher losses in the future. Although credit unions and building societies have also experienced low impairment rates, some of the regional banks have experienced higher loss rates.<sup>13</sup>

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12 Australian Prudential Regulation Authority 2014, First round submission to the Financial System Inquiry.

13 Reserve Bank of Australia (RBA) 2014, *Chart Pack: The Australian Economy and Financial Markets*, June, Sydney, page 29, viewed 20 June 2014, <<http://www.rba.gov.au/chart-pack/pdf/chart-pack.pdf>>.

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- The aggregate regulatory capital requirements of an ADI should reflect its overall risk profile. Although small ADIs may benefit from detailed knowledge of their customers, they also have relatively concentrated loan books and, in the case of credit unions and building societies, limited capacity to raise new equity. They also tend to have less sophisticated risk management systems, albeit with less complex risks. These factors suggest smaller ADIs may need higher regulatory capital buffers than their larger competitors.

The Inquiry considers smaller ADIs most likely face a disadvantage due to the differences between standardised risk weights and risk weights determined by IRB models. However, the extent of the disadvantage would be difficult to determine and would vary between ADIs over time, depending on the riskiness of their assets.

Standardised risk weights do not provide incentives for the ADIs that use them to reduce the riskiness of their lending, as this would not reduce their risk weights. Conversely, IRB banks receive strong incentives to reduce the riskiness of their lending.

### Policy options for consultation

Submissions identify a number of options to address the consequences of the differences between standardised and IRB risk weights:

- It may be possible for **Government or APRA to work with smaller ADIs to help them attain IRB accreditation**. Submissions indicate some non-IRB banks are actively considering how to attain IRB accreditation, but are finding this difficult. The Inquiry would welcome views on how Government or APRA may be able to assist with this.
- Another option could be to **increase the risk weights for IRB banks**. This could involve setting a minimum risk weight for mortgages determined by IRB models, or indirectly determined by setting or increasing floors for key parameters in IRB models. For example, for stability reasons, APRA already requires that IRB banks assume a 20 per cent 'loss given default' rate for their mortgage book, even when their models produce a lower rate. Increasing the risk weights for IRB mortgages could increase stability and competition, and incentivise more lending away from housing; although, it could also increase costs for IRB banks and may therefore reduce efficiency.
- In its submission, APRA notes that risk weight floors have been introduced in Sweden and Hong Kong, and the BCBS is investigating measures, such as floors and benchmarks, to limit risk weight variability while retaining appropriate risk sensitivity. However, the prospective introduction of floors and analysis by the BCBS is driven primarily by stability rather than competition concerns, and is not limited to mortgage lending.

Other suggested options would have trade-offs between stability and competition. They would also be inconsistent with Australia’s commitment to the Basel framework, and so may risk the international reputation of Australia’s banking system.

- It may be possible to **develop a tiered system of standardised risk weights** that incorporates some components of IRB models. Such a system could potentially be more accurate than standardised risk weights, while less burdensome than IRB modelling. The Inquiry welcomes views on how such an option could be implemented.
- A number of submissions propose APRA should **lower standardised risk weights for mortgages**.<sup>14</sup> This option would have several drawbacks. It could lower the incentive to improve risk management models and further incentivise non-IRB ADIs to undertake mortgage lending, rather than business or personal lending. This option could also increase risk, which could increase funding costs.
- A final option would be to **allow smaller ADIs to adopt IRB for residential mortgages only**, rather than for all asset classes. This would likely only benefit mid-tier ADIs that have the capacity to model their own mortgage risk weights. This option could also reduce stability, as the IRB accreditation process is designed to ensure ADIs manage their entire loan book effectively – and this would be lost.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements
- Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation
- Increase minimum IRB risk weights
- Introduce a tiered system of standardised risk weights
- Lower standardised risk weights for mortgages
- Allow smaller ADIs to adopt IRB modelling for mortgages only

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<sup>14</sup> For example, the Regional Banks’ submission to the Financial System Inquiry on behalf of Bank of Queensland, Bendigo and Adelaide Bank, ME Bank and Suncorp Bank proposes lowering standardised risk weights for mortgages to 20 per cent.

*The Inquiry seeks further information on the following area:*

How could Government or APRA assist smaller ADIs to attain IRB accreditation?

## Funding costs

The major banks have lower wholesale funding costs than their smaller competitors. A significant part of this advantage is derived from commercial and market factors, including the major banks' size, their greater access to capital, the diversity of their lending portfolios and their sophisticated risk management systems. Although the funding advantages accruing from these factors may be a natural consequence of size, some submissions argue that other factors disadvantage smaller ADIs, namely:

- A perception that some banks are too big for Government to allow them to fail, which may lead to creditors lending to these banks at a lower rate
- The collapse in the residential mortgage-backed securities (RMBS) market following the GFC

## Preliminary assessment

### *The impact of perceptions of too-big-to-fail on wholesale funding costs*

A number of submissions argue that large banks receive an additional funding advantage, as they are perceived as too-big-to-fail.<sup>15</sup> The *Stability* chapter explores this in more detail. In short, creditors may believe that, in times of crisis, the Government will provide taxpayer support to banks whose disorderly failure could damage other parts of the economy. Thus, creditors may be willing to lend to these banks at a reduced rate.

It is difficult to estimate the size of any possible funding cost advantage that the perception of being too-big-to-fail provides large banks. This is in large part due to different creditors having different perceptions around risk. A number of organisations have attempted to estimate the potential funding advantage; however, estimates vary depending on the methodology used.<sup>16</sup> Any advantage is also likely to

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15 Submissions to the Financial System Inquiry include those by the Customer Owned Banking Association, the Regional Banks and Yellow Brick Road.

16 International examples include: Schich, S and Lindh, S 2012, 'Implicit Guarantees for Bank Debt: Where Do We Stand', *OECD Journal: Financial Market Trends*, vol 2012, issue 1, OECD; and Santos, J 2014, 'Special Issue: Large and Complex Banks', *Federal Reserve Bank of New York Economic Policy Review*, vol 20, no. 2, New York. Australian studies are scarcer, but include: International Monetary Fund (IMF) 2012, 'Australia: Addressing Systemic Risk through Higher Loss Absorbency – Technical Note', *IMF Country Report no. 12/311*, IMF, Washington.

fluctuate over time, and could be transient if Government policies effectively reduce the systemic risks posed by large banks.<sup>17</sup>

### *The residential mortgage-backed securities market*

During the GFC, the RMBS market became dislocated and the cost of RMBS as a funding source for mortgage lenders increased. This disproportionately affected smaller ADIs and non-bank lenders, which rely more heavily on these markets for funding, and compounded the wholesale funding cost advantage that the larger banks already had. The introduction of the Financial Claims Scheme (FCS), which protects retail bank deposits up to \$250,000, also affected non-bank lenders, who could not benefit from it.

Before the GFC, short-term debt and securitisation provided a cost-effective form of funding that allowed smaller ADIs and non-bank lenders to compete with the major banks. In 2007, smaller ADIs and non-bank lenders accounted for approximately 70 per cent of RMBS issuance (Chart 2.1). Investor demand for RMBS fell during the GFC, with RMBS spreads increasing by over 100 basis points by 2012.<sup>18</sup> At the same time, smaller ADIs found it difficult to access wholesale debt markets. The Government directed the Australian Office of Financial Management to purchase RMBS securities to support the market, but many non-bank lenders were forced to reduce their lending or change their business models.<sup>19</sup>

The Government has now closed its RMBS purchase program and the market has started to recover, with issuance of over \$20 billion in 2013 (Chart 2.1). However, the RBA does not expect the market will return to pre-GFC levels in the near future.<sup>20</sup>

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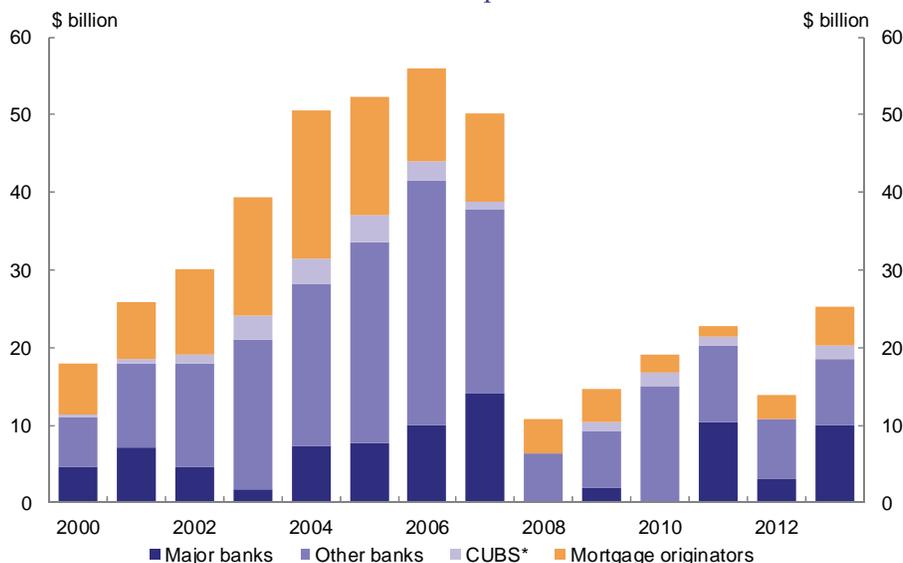
17 Oliver Wyman 2014, *Do Bond Spreads Show Evidence of Too Big To Fail Effects*, April.

18 Westpac, RP Data, cited in Joye, C 2012, 'Credit where it's due to RMBS', *The Australian Financial Review*, 2 November.

19 Australian Office of Financial Management 2013, *Residential Mortgage-backed Securities*, viewed 11 June 2014, <<http://aofm.gov.au/cash-management-and-investments/residential-mortgage-backed-securities/>>.

20 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry.

**Chart 2.1: RMBS issuance by financial institution type**  
Australian dollar equivalent, annual



\*CUBS = Credit unions and building societies.  
Source: RBA.

Further, smaller ADIs have relied more on deposit funding since the GFC, which has become relatively more expensive as all ADIs have shifted towards deposit funding and away from short-term debt.<sup>21</sup> This has further reduced the competitive position of smaller ADIs.

It is not clear if changes in the RMBS market, and the associated deterioration in the competitive position of smaller ADIs and non-bank lenders, relate to an ongoing market failure. For example, the increase in RMBS spreads likely relates to a correction in the price of RMBS to reflect risk, rather than any ongoing issues with the market.

## Policy options for consultation

### *Too-big-to-fail*

A number of submissions propose measures to reduce the potential funding benefit arising from perceptions of too-big-to-fail. The Inquiry considers the best way to deal with any potential competition issues is by directly addressing the systemic risks posed by large banks. Potential policy responses to achieve this aim are discussed in the *Stability* chapter. They include:

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<sup>21</sup> Reserve Bank of Australia (RBA) 2014, *Statistical Table: Retail Deposit and Investment Rates – F4*, RBA, Sydney.

- Increasing the ability to impose losses on a failed financial institution’s creditors
- Strengthening regulators’ resolution powers for financial institutions, and investing more in pre-planning and pre-positioning for financial failure
- Increasing capital requirements on the most systemically important financial institutions

Other proposals that submissions raise include charging the major banks to ameliorate the funding disadvantage, or to explicitly guarantee all ADIs. The Inquiry does not consider that there is a case for options of this nature. Charging for a perceived funding advantage may strengthen the perception of Government support. Explicitly guaranteeing all ADIs would create significant moral hazard, expose taxpayers to very large contingent liabilities and put non-bank lenders at a competitive disadvantage.

### *Residential mortgage-backed securities*

Some submissions argue that the Government should support the RMBS market to reduce funding costs for smaller ADIs and non-bank lenders, and to promote competition. The options include:

- Introducing a new RMBS purchase program, which could potentially focus on purchasing lower-rated tranches
- Purchasing housing loans from small lenders and issuing RMBS, or establishing a joint public-private sector body to undertake this function, along the lines of the Canadian approach or Fannie Mae and Freddie Mac in the United States

Before recommending such interventions, the Inquiry would need to be convinced of a clear market or regulatory failure in the RMBS market. Although Government support may have been appropriate during the crisis, the recent market recovery weakens the case for further intervention. All options, to varying degrees, would create contingent liabilities for taxpayers. The options may also require the Government to intervene in the market to ensure lending standards and could potentially create moral hazard.

Other proposals involve changes to regulatory arrangements governing ADI issuance and investment in RMBS. Some submissions suggest RMBS be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio. This would encourage major banks to purchase RMBS from smaller ADIs and non-bank lenders, as it could be a cheaper way of meeting these requirements than holding Commonwealth Government Securities or paying the fee for the committed liquidity facility. At present, RMBS holdings are only eligible as collateral for the RBA’s committed liquidity facility.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements
- Provide direct Government support to the RMBS market
- Allow RMBS to be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio

## Small business and personal lending

Approximately 50 per cent of small businesses rely on bank loans to fund their businesses.<sup>22</sup> Small businesses do not have access to the alternative funding channels available to larger corporations, such as debt market funding. This makes them more dependent on bank credit.

Individuals can access unsecured loans through a number of means, including personal loans and some credit cards. Individuals relying on loans from these sources may not have access to cheaper sources of financing.

### Preliminary assessment

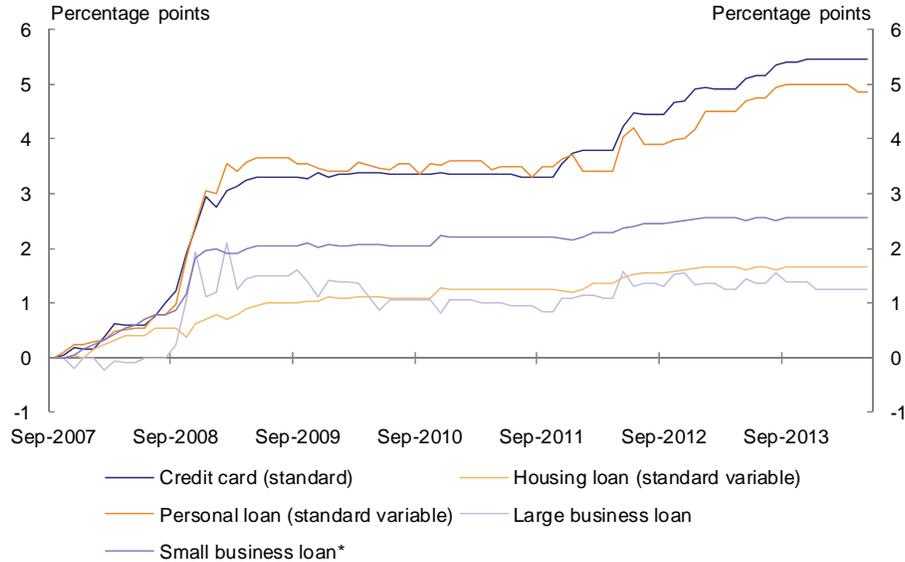
During the GFC, the spreads between lending rates and the cash rate increased for all loans. However, spreads for SME and personal lending increased by more than spreads for mortgages and corporate loans (Chart 2.2), which largely increased in line with banks' funding costs.<sup>23</sup> Terms of lending also tightened. This has generated concerns about the strength of competition in the SME and personal lending sectors.

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<sup>22</sup> Australian Bankers' Association and Council of Small Business Australia 2013, *Small Business: Access to Finance Report, Year to March 2013*.

<sup>23</sup> Robertson, B and Rush, A 2013, *Developments in Banks' Funding Costs and Lending Rates*, Reserve Bank of Australia, Sydney.

**Chart 2.2: Changes in spreads to cash rate for different loan types since September 2007**



\*Spreads for small business loans are for residentially secured small business loans.  
Source: RBA.<sup>24</sup>

However, the increase in SME and personal lending spreads reflects, at least in part, a re-evaluation of risk in these lending categories and a general increase in the price of risk. As SME and personal lending is more risky than mortgage and corporate lending, it follows that their spreads increased by a greater margin.<sup>25,26</sup> It is not clear if any of the increase in spreads was due to reduced competition.

The Inquiry would welcome views on whether there is evidence that spreads in SME and personal lending reflect reduced competition.

### Policy options for consultation

Most policy suggestions relate to how the SME lending market operates, rather than the level of competition. The *Funding* chapter discusses options that may improve the funding environment for SMEs.

24 Reserve Bank of Australia (RBA) 2014, *Statistical Table: Indicator Lending Rates – F5* and *Statistical Table: Interest Rates and Yields – Money Market – Monthly – F1.1*, RBA, Sydney.

25 Reserve Bank of Australia (RBA) 2014, *Chart Pack: The Australian Economy and Financial Markets*, June, RBA, Sydney, page 30, viewed 20 June 2014, <<http://www.rba.gov.au/chart-pack/pdf/chart-pack.pdf>>.

26 Australian Prudential Regulation Authority 2014, First round submission to the Financial System Inquiry, page 79.

Some submissions suggest expanding comprehensive credit reporting (CCR). CCR was introduced in March 2014 to enable market participants to share consumers' repayment histories. CCR expands on the previous credit reporting regime, where market participants could only share negative credit events, such as a default. The shift from a negative to a positive credit reporting system has the potential to promote competition by enabling credit providers to more accurately assess the credit worthiness of borrowers, and to compete for customers by offering risk-based pricing.

However, CCR is voluntary and the Inquiry understands that, to date, none of the major banks have participated. This is likely because the cost of sharing their information with competitors is greater than the benefit of gaining access to other competitors' databases. Some submissions propose making CCR mandatory, which may improve the value of CCR for smaller lenders.

Some submissions also suggest increasing the number of fields reported to include additional information, such as outstanding account balances. This could further address information asymmetries in the credit assessment processes and enable risk assessment at a more granular level. These benefits would need to be balanced against privacy concerns, as well as the upfront investments credit providers make in establishing customer relationships.

Another option could be to extend credit reporting to SMEs. This may have the potential to improve SME credit risk assessments and improve SME access to funding.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements
- Expand CCR by making it mandatory, adding new fields and/or extending it to SME lending

*The Inquiry seeks further information on the following area:*

Is there evidence that spreads in SME and personal lending reflect reduced competition?

## Comparing and switching between banking products

Competition relies on consumers being able to compare the value of different products. Since the Wallis Inquiry, technology has enabled the growth of online aggregators and price comparison websites that better enable consumers to compare

value. In the banking sector, aggregators have focused on mortgages, term deposits and savings accounts.

However, there is little gain in improving the capacity of consumers to compare the value of products if there are impediments to switching between products. The Government and industry have reduced switching costs for banking products since the Wallis Inquiry, and a number of industry trends will further lower costs in the future.

### Preliminary assessment

#### *Comparing banking products*

Some product terms can reduce the functionality of aggregators. For example, account aggregators enable consumers to view several bank accounts through one interface and identify alternative banking products that may offer superior value. However, where a consumer permits an aggregator to access their account, this may constitute a breach of the account terms and conditions. Consequently, the consumer may have invalidated protections they would otherwise have been afforded in cases of fraud or stolen funds.

#### *Switching banking products*

Several submissions identify low rates of transaction account switching as an obstacle to improving banking competition. Roy Morgan Research estimates that 3.2 per cent of consumers switch their main financial institution each year.<sup>27</sup> This means that, on average, consumers switch approximately every 30 years. The Government introduced a transaction account switching tool in 2011 to help consumers transfer their direct debits and credits. However, take-up of the service has been low, with only 17,500 people using the system in 2013.<sup>28</sup>

Some submissions argue that the Government should go further and introduce full account portability. The New Payments Platform industry initiative facilitated by the Australian Payments Clearing Association and RBA may assist in this regard. One of the platform's build requirements is for consumers to be able to attach a unique address, such as their mobile phone number or email address, to their bank account. Implementation of this addressing system will begin in 2016.<sup>29</sup> Direct debits and credits could then be made to addresses, rather than underlying bank account numbers, which would allow a consumer to change accounts without switching

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27 Roy Morgan Research 2014, data provided to the Financial System Inquiry. Note: the statistic refers to the Australian population aged 18 years and over that switched their main financial institution in the 12 months before April 2014.

28 Treasury 2014, data provided to the Financial System Inquiry.

29 Australian Payments Clearing Association 2013, *Real-Time Payments, Summary of RTPC Proposal to the Payments System Board*, viewed 20 June 2014, <<http://apca.com.au/docs/real-time-payments/real-time-payments-summary.pdf>>.

address. In addition, consumers with multiple accounts would be able to use multiple addresses. Such a system could also work for new banking products that do not use bank account numbers.

However, the introduction of the new platform would not connect existing direct debits and credits to consumers' addresses. This means the benefits would accrue over time, as consumers roll over their direct debits and credits and attach them to their address.

Steps have also been taken to improve switching for mortgages. The Government banned exit fees for mortgages in 2011. Industry initiatives, such as e-conveyancing, are also likely to reduce switching costs. Future initiatives could further assist, including a national e-mortgage regime, standardised mortgage discharge forms and timelines, and improved online identity verification processes, as discussed in the *Technology* chapter.

## Four pillars policy

In 1990, the then Government introduced a 'six pillars' policy whereby the four major banks and two major life insurers were prevented from merging with one another. This has since evolved into the 'four pillars' policy maintained today, which applies to the four major banks.

The policy arguably assists with both competition and stability. For competition, it ensures that the banking sector does not become overly concentrated, which could materially lessen competition. For stability, if larger and more systemically important banks fail, they tend to be more difficult to resolve in an orderly fashion, so four pillars may assist by limiting the size of Australia's largest banks.

In its final report, the Wallis Inquiry recommended abolishing the (then) six pillars policy. It argued that general competition law was sufficient to address competition issues in the banking sector. This reflected the Wallis Inquiry's philosophy that competition in the financial sector should be treated no differently to other sectors of the economy. The Wallis Inquiry also saw little stability benefit, given the major banks were already very large.

Successive governments have maintained the four pillars policy. The Inquiry views this as appropriate and does not plan to recommend changes. The banking sector is already concentrated; further significant concentration has the potential to limit competitive pressure in the market and reduce the choices available to Australian individuals and firms. Although general competition law may prevent a merger between the major banks, the Inquiry sees merit in retaining the four pillars policy.

## The concentration and integration of the major banks

The major banks have increased concentration and integration in the banking sector through acquiring other banks and integrating with mortgage brokers. Mortgage brokers enable consumers to compare the value of different banking products better, including mortgages, personal loans and term deposits. The major banks have also integrated horizontally and vertically into other sectors of the financial system, including wealth management and insurance.

### Increased market power

Some submissions argue that the increasing concentration and integration of the major banks is harming competition. They submit the major banks can cross-subsidise products to drive out competitors in some markets. Submissions also argue that the major banks' market power has led to oligopolistic competition and higher prices for consumers.

The major banks have market power across a range of markets. However, it is not clear they are abusing this power. The ACCC has taken relatively little action against the major banks in recent years. The Inquiry would welcome views on the level and exercise of market power across the various markets in which the major banks operate.

### Vertical integration of mortgage brokers

Vertical integration of mortgage broking may create conflicts of interest, which could hamper competition. Mortgage brokers can improve competition by enabling smaller players to access a broader range of consumers than their standard distribution networks would allow. However, vertical integration may have the potential to distort the way in which mortgage brokers direct borrowers to lenders. The extent of this issue is not clear. The Inquiry welcomes views on this issue.

#### *The Inquiry seeks further information on the following area:*

- Is integration in the banking sector causing competition issues?
- Is vertical integration distorting the way in which mortgage brokers direct borrowers to lenders?
- If so, what would be the best way to limit the adverse impacts?

## Lenders mortgage insurance

Lenders mortgage insurance (LMI) protects a lender against default by a borrower, if there is a shortfall after realising the security. Lenders use LMI to make loans to

borrowers with low deposits (usually where the loan-to-valuation ratio (LVR) is greater than 80 per cent) or without a regular earnings record, such as the self-employed. About one-quarter of new mortgage loans are covered by LMI,<sup>30</sup> which is generally paid by the borrower.

### Preliminary assessment

Under Basel I, lenders were able to apply a lower risk weight to loans with a high LVR or to non-standard loans if they were covered by LMI. This incentive does not exist under Basel II for IRB banks, as APRA's floor of 20 per cent for the loss given default on residential mortgages means that the risk weight is the same, whether or not the mortgage is covered by LMI.

Some submissions argue that, under these policy settings, the major banks will reduce or stop their use of LMI, as they can carry the default risk themselves and have no capital incentive. They state the LMI industry may not be viable as the market size reduces and major banks accept lower-risk, high-LVR loans, leaving higher-risk loans in the LMI pool. This may in turn reduce access to mortgage lending for those with low deposits or the self-employed. It could also increase the major banks' competitive advantage over RMBS issuers and smaller ADIs that seek the risk protection of LMI.

### Policy options for consultation

Submissions propose policy changes to re-establish the place of LMI in mortgage lending, including changes to capital standards to decrease the risk weights for insured loans. They contend such changes could improve the competitive position of smaller ADIs and non-bank lenders, maintain broad access to mortgage loans and assist with system stability by providing more capital in the system. However, this option could involve trade-offs:

- There could be stability implications. In its submission, APRA states that the 20 per cent loss given default floor for housing lending has been set until IRB banks develop appropriate methodologies and estimates for a downturn period.
- Decreasing risk weights for insured loans may affect the competitive situation between IRB banks and smaller lenders.

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<sup>30</sup> QBE 2014, First round submission to the Financial System Inquiry.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:*

- No change to current arrangements
- Decrease the risk weights for insured loans

## Payments sector

Payment systems are networks that enable individuals, businesses, banks and other financial system participants to make and receive payments.

Submissions on payment systems covered:

- Interchange fees, merchant service fees and customer surcharging
- The competitive neutrality of regulation for different debit payment systems

## Overview of payment schemes and participants

Two of the largest payment systems in value terms are the Direct Entry system, which processes direct debits and credits between bank accounts, and the Real Time Gross Settlement System, which processes inter-bank fund transfers. However, submissions do not raise competition issues about these systems.

The primary focus of submissions is on debit and credit card systems. These are now used almost as frequently as cash for consumer transactions and are therefore of considerable importance to customers and retailers (merchants).<sup>31</sup> Debit card systems link customer payments to their transaction accounts, while credit card systems enable customers to pay for purchases using credit.<sup>32</sup> Both systems generally function for both point-of-sale transactions and online transactions. In addition, new online-only payment schemes have begun to emerge, which often interlink with traditional payment schemes.

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31 Ossolinski, C, Lam, T and Emery, D 2014, *The Changing Way We Pay: Trends in Consumer Payments*, Research Discussion Paper 2015-05, Reserve Bank of Australia, Sydney.

32 Some debit cards also work on a pre-paid basis and are known as stored value cards. Charge cards are a variation of credit cards and require cardholders to pay their outstanding balance monthly, instead of providing a revolving line of credit.

eftpos, which is owned by a number of financial institutions and retailers, is the largest **debit card** payment scheme provider. Its main competitors are MasterCard and Visa, which are increasing their share in that market.<sup>33</sup>

In comparison, MasterCard and Visa are the main providers of **credit card** payment schemes, with a combined market share of 80.7 per cent.<sup>34</sup> For these schemes, the financial institutions that issue the cards (see issuers below) provide the credit. The main competition for credit card schemes comes from American Express (Amex) and Diners Club, which provide credit for the cardholder in addition to operating the scheme network. Their combined market share has increased from 14.6 per cent of the value of transactions in April 2003 to 19.3 per cent in April 2014.<sup>35</sup>

To date, PayPal has been the most successful **online payment** provider, although there is continuing innovation and market entry in this area.

A number of participants compete within debit card and credit card payment schemes. They compete on issuing payment cards and associated services to customers and providing acceptance facilities and associated services to merchants. The major banks are the main **issuers** of payment cards, with competition from most other ADIs and a number of non-bank issuers. The major banks are also the main providers of acceptance facilities, with competition from other ADIs and Tyro. In addition, some of the largest merchants, including the major supermarkets, have in-house payment acceptance facilities.

Other payment systems include Automatic Teller Machine (ATM) networks, cheques and BPAY. However, submissions do not focus on them from a competition perspective. The Inquiry would welcome views on whether there are competition issues with these systems or any other parts of the payments sector.

### Regulation of debit card and credit card schemes

Payment schemes are regulated by two main instruments under the Payment Systems (Regulation) Act: access regimes and standards. The RBA has designated the eftpos, MasterCard and Visa payment schemes under the Act and applied access regimes, primarily to ensure that smaller and non-ADI participants could enter and compete in these markets. Standards cover scheme pricing arrangements, or interchange fees, and the removal of restrictions on merchants, such as in relation to customer surcharging.

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33 eftpos 2014, First round submission to the Financial System Inquiry.

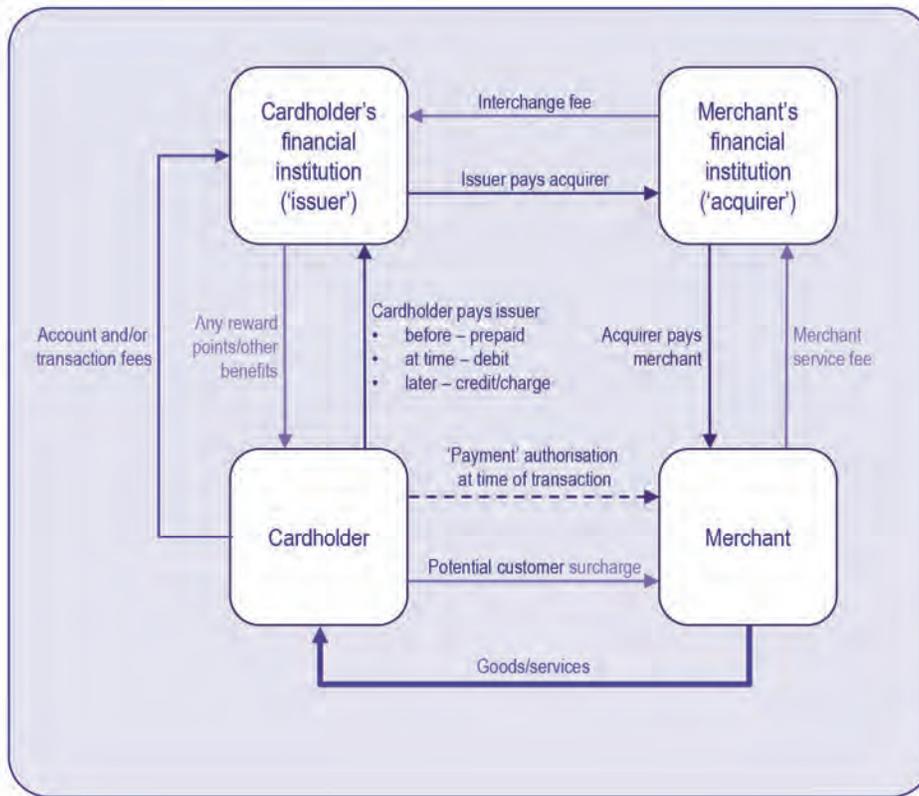
34 Reserve Bank of Australia (RBA) 2014, *Statistical Table: Market Shares of Credit and Charge Card Schemes – C2*, RBA, Sydney.

35 Reserve Bank of Australia (RBA) 2014, *Statistical Table: Market Shares of Credit and Charge Card Schemes – C2*, RBA, Sydney. Note: due to a series break in March 2008, the increase in market share is over-represented by 1.5 percentage points.

*Interchange fees*

Interchange fees are often a feature of four-party payment card schemes (Figure 2.1), which include the debit and credit schemes operated by eftpos, MasterCard and Visa. Acquirers, the merchants’ providers of payment acceptance facilities, pay interchange fees to issuers, the cardholders’ payment card providers. The fees enable issuers to recover the cost of processing transactions. Payment schemes can also set interchange fees to incentivise financial institutions to issue their payment cards. Issuers can incentivise cardholders to use their cards by passing on a proportion of interchange fees as reward points, interest-free periods or other benefits.

**Figure 2.1: Simplified example of a four-party payment scheme**



Payment schemes designated by the RBA (eftpos, MasterCard and Visa) ensure that the weighted-average value of their interchange fees complies with caps established by the RBA. The caps are 0.5 per cent of the value of transactions for credit card schemes and 12 cents per transaction for debit card schemes. The RBA established these caps following a cost-based benchmarking exercise.

The RBA caps interchange fees for a number of reasons.

- **Price signals are not efficient in four-party payment schemes**, which can result in competition and paradoxically lead to higher prices. Merchants generally exhibit low price sensitivity to merchant service fees for widely used payment schemes, such as those operated by eftpos, Visa and MasterCard. If merchants do not accept these cards, they may lose sales to the majority of merchants that do. In comparison, cardholders are often more price sensitive. They have access to a range of payment schemes, and will respond to incentives like reward points when determining which scheme to use. Payment schemes therefore have an incentive to set high interchange fees, which issuers can use to offer reward points for cardholders.
- **Interchange fees act like price floors** for merchant service fees. To break even, at a minimum, acquirers set merchant service fees at the cost of interchange fees, plus the cost of processing transactions.
- **Cross-subsidisation will occur** if merchants do not recover merchant service fees through customer surcharges. The cost of absorbing merchant service fees would be reflected in higher prices for goods and services. This would result in cross subsidisation from customers using low-cost payment mechanisms, such as eftpos and cash, to those using high-cost payment schemes – an inefficient outcome.

Amex and Diners Club operate three-party payment schemes. In three-party schemes, the scheme takes the role of issuer and acquirer. As no interchange fees are involved, these schemes are not covered by interchange fee regulation. Issues with the regulation of a variation of three-party schemes, known as companion cards, are discussed below.

### *Customer surcharging*

Since 2003, the RBA has required payment schemes to remove ‘no surcharge’ rules so merchants can pass on the reasonable costs of card acceptance, such as merchant service fees, to cardholders. These standards apply to both three-party and four-party schemes, but not to online payment system providers.<sup>36</sup> Allowing merchants to surcharge introduces a price signal to customers about the cost of the payment mechanism they use and can help reduce the effects of the interchange fee issues highlighted previously.

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<sup>36</sup> The standards only apply to four-party payment schemes; however, the three-party payment schemes have provided voluntary undertakings to comply with them.

**Table 2.1: Summary of payment system regulation**

System	Type	Interchange fee regulation	Customer surcharging regulation
eftpos debit	Four-party	Weighted-average cap of 12 cents per transaction	No explicit prohibition on 'no surcharge' rules, but no such rules applied
MasterCard/Visa debit	Four-party	Weighted-average cap of 12 cents per transaction	Prohibition of 'no surcharge' rules
MasterCard/Visa credit	Four-party	Weighted-average cap of 0.5 per cent of transaction values	Prohibition of 'no surcharge' rules
Amex/Diners Club credit	Three-party	No regulation (no interchange fees to regulate)	Voluntary undertaking to refrain having from 'no surcharge' rules
Amex companion cards	In between three-party and four-party	No regulation (only service fees, which are not regulated)	Voluntary undertaking to refrain from having 'no surcharge' rules
Online payment systems	Variety of models, often linked to other systems	No regulation	No regulation

## Preliminary assessment

### *Observation*

Regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral.

## Interchange fees

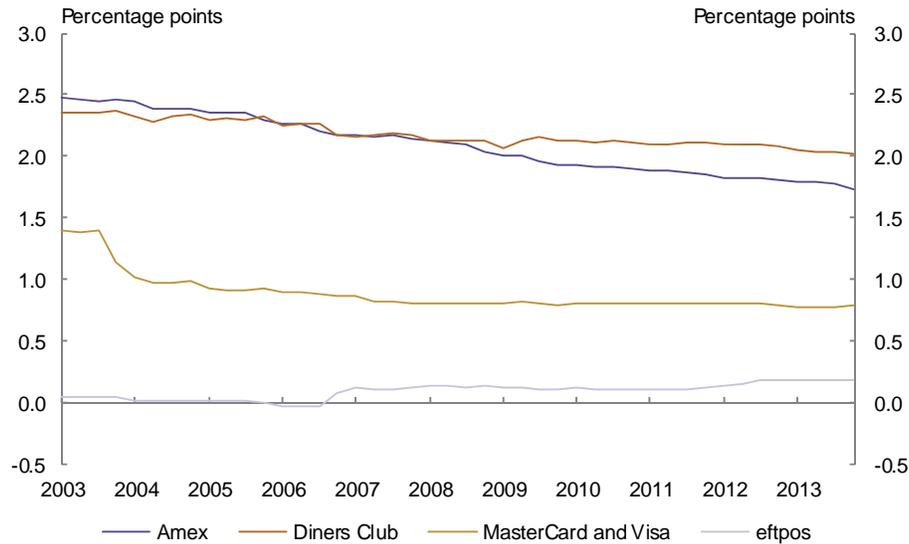
### *Efficiency*

The RBA submission argues that interchange fee caps have reduced merchant service fees, citing that merchant service fees declined for MasterCard and Visa credit card schemes shortly after interchange fee caps were introduced in the early 2000s (Chart 2.3).

Merchant service fees also fell for the non-designated Amex and Diners Club schemes. This suggests these schemes responded to the lower prices of the designated schemes, potentially because merchants have more bargaining power in relation to three-party payment schemes. Merchants know they are unlikely to lose business if they do not accept three-party scheme cards, because most three-party scheme cardholders also hold four-party scheme cards.

Although eftpos debit card fees have increased, they are still lower than fees for other schemes. Initially, they were negative because issuers paid acquirers to use the system to incentivise take-up.

**Chart 2.3: Merchant service fees as a percentage of transaction values**



Source: RBA.

Submissions from MasterCard and Visa argue that interchange fee caps are not efficient, as they benefit merchants rather than cardholders. They contend that, although the caps may have reduced costs for merchants, they have also lowered the value to cardholders, limiting reward points and potentially making credit card fees and interest rates higher than they would have been.

On balance, the Inquiry considers that interchange fee caps have improved the functioning of four-party payment schemes. They have reduced merchant service fees. Although difficult to measure, they have also likely reduced cross-subsidisation across payment mechanisms. It may be possible to build on these efficiencies by lowering interchange fee caps or by applying caps to arrangements of similar economic substance across the payments sector.

### *Companion cards*

Companion cards, which typically operate through the Amex scheme, are issued by ADIs. Companion cards can be thought of as a blend of three-party schemes and four-party schemes. The scheme is the acquirer, but an ADI is the issuer.

Submissions from MasterCard and Visa argue that the service fees companion card schemes pay to issuers are equivalent to interchange fees in four-party payment schemes, as they are both payments made to issuers funded by merchant service fees.

They submit that payment scheme regulation lacks competitive neutrality because these service fees are not capped, which allows companion card schemes to provide more generous incentives to issuers and cardholders to incentivise take-up. They point to the increase in the market share of Amex.

Amex argues the service fees it pays to ADIs for its companion cards are more akin to the incentive payments that MasterCard and Visa pay issuers in four-party schemes. It notes that, unlike interchange fees, which are set by payment schemes for all ADIs, companion card service fees are negotiated bilaterally between the scheme and individual ADIs.

The Inquiry considers that payment systems of similar economic substance should be regulated consistently. An argument could be made that four-party interchange fees, companion card service fees and incentive payments under all schemes are equivalent in economic substance. The Inquiry would welcome stakeholder views on this matter.

### *Merchant routing choice*

Payment cards issued by banks and other financial institutions often provide cardholders with access to more than one payment scheme. This enables cardholders to choose which scheme to pay with by selecting 'savings' or 'credit' at the terminal.<sup>37</sup> It also potentially enables merchants to choose which debit scheme to route debit transactions through. The Australian Retailers Association submits that many acquirers do not provide merchants with the opportunity to route transactions through their payment scheme of choice. This reduces both merchants' ability to choose low-cost acceptance schemes and the incentives for debit schemes to operate as efficiently as possible.

### *Impacts on small merchants*

Interchange fees are not applied evenly to all transactions. Instead, schemes must ensure that weighted-average fees fall below the cap. Large merchants with more market power are often able to secure lower interchange fees than smaller merchants. This difference in purchasing power can reduce small retailers' ability to compete with large retailers.

### *Customer surcharging*

Allowing merchants to surcharge customers for the reasonable cost of acceptance improves efficiency by providing cardholders with clearer price signals about the costs of different payment mechanisms. Therefore, 'no surcharge' rules can reduce efficiency. 'No surcharge' rules do not apply to other traditional mechanisms, such as

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<sup>37</sup> However, for contactless transactions, customers are automatically routed through the scheme that provides the contactless facility.

## Financial System Inquiry — Interim Report

cash and cheques. The RBA considers customer surcharging appropriate for any payment mechanism where merchants incur acceptance costs.<sup>38</sup>

However, submissions raise some issues with surcharging for debit card and credit card transactions that warrant consideration:

- If merchants over-surcharge customers, they will skew price signals and make the payments system less efficient. Submissions raise concerns that some merchants, particularly in the airline and ticketing industries, over-surcharge. Scheme operators argue they are not well placed to control this behaviour because they do not have direct relationships with merchants. However, the Inquiry notes that they were generally able to enforce 'no surcharge' rules when they were in place.
- Submissions from MasterCard and Visa argue that some merchants surcharge the same amount for their cards as for the more expensive Amex and Diners Club cards. They argue that this unfairly reduces the volume of payments made using their schemes. However, evidence suggests that, on average, merchants surcharge Amex cardholders more than MasterCard and Visa cardholders.<sup>39</sup>
- Submissions also note that online payment system providers are still able to impose 'no surcharge' rules, which is not competitively neutral. As noted above, the Inquiry considers payment systems operate most efficiently when merchants have the capacity to recover the reasonable cost of acceptance.

## Policy options for consultation

### Interchange fees

Stakeholders suggest a number of ways to reform interchange fee regulation:

- **Lower interchange fee caps.** Although, in Australia, interchange fees are currently set to approximate the cost of processing transactions, other jurisdictions such as Europe apply a merchant indifference test. This test aims to set interchange fees at a level that makes merchants indifferent to which payment mechanism a customer uses, resulting in lower fee caps than in Australia. An argument could potentially be made for banning interchange fees altogether, which would require issuers to

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38 Richards, T 2014, *Transcript of Question and Answer Session with Tony Richards, Head of Economic Analysis Department*, Reserve Bank of Australia, Sydney, 4 June, viewed 23 June 2014, <[http://static.knowledgevision.com/account/brr/assets/attachment/RBA/RBA\\_Speech\\_QA\\_transcript\\_Tony\\_Richards\\_4\\_June\\_2014\\_2\\_1\\_1\\_.pdf](http://static.knowledgevision.com/account/brr/assets/attachment/RBA/RBA_Speech_QA_transcript_Tony_Richards_4_June_2014_2_1_1_.pdf)>.

39 Reserve Bank of Australia (RBA) 2013, *Payment System Board Annual Report: 2013*, RBA, Sydney, page 34.

recover the cost of processing transactions directly from consumers. Although lowering fee caps for four-party schemes may make these schemes more efficient, it could exacerbate issues around competitive neutrality with companion cards. In addition, if caps are set too low, it could risk the viability of some participants' business models.

- **Expand interchange fee caps to capture other payments of similar economic substance.** This could include service fees under companion card schemes and incentive payments under all schemes. This would ensure competitive neutrality between different schemes. It would also mean that schemes compete less on incentive payments and award points to drive take-up by customers and more on improving cost efficiencies, innovations and system performance. It could address submission concerns that the current designation process is open to inconsistencies and involves considerable upfront compliance costs.
- **Remove interchange fee caps.** The MasterCard and Visa submissions argue for this option, partly on the basis that service fees under companion card schemes are not regulated. Given the benefits interchange fee caps have delivered, it may be more effective to address any competitive neutrality issue by consistently regulating fees of similar economic substance.
- **Cap merchant service fees.** The Australian Retailers Association argues that this could ensure retailers pay similar merchant service fees, no matter their strategic importance to scheme providers. Small merchants generally pay higher fees than large merchants. However, regulating merchant service fees would act like a price control on the final product, representing a more interventionist approach. It may also harm innovations that deliver considerable benefits to merchants but cost more than current practice. A less interventionist approach could involve setting limits on how much interchange fees could vary between merchants.
- **Require acquirers to enable merchants to choose which scheme to route transactions through once customers have selected debit or credit.** Submissions note this option would improve competition by incentivising schemes to reduce their costs.

## Customer surcharging

Stakeholders suggest a number of ways to reform customer surcharge regulation:

- **Allow schemes to reintroduce 'no surcharge' rules or ban 'no surcharge' rules for all payment systems.** Some submissions argue for the return of 'no surcharge' rules. They contend that some surcharging provides inaccurate price signals and is therefore inefficient. They also argue that it puts regulated payment schemes at a disadvantage to unregulated, online payment systems that can still apply 'no surcharge' rules. The Inquiry is predisposed to address instances where surcharging is inaccurate, rather than allow surcharging to be banned.

- **Enforce reasonable cost recovery in customer surcharging.** Submissions from payment schemes suggest this option; however, it is not clear that payment schemes need regulator assistance with enforcing reasonable surcharging, given that previously they were able to enforce ‘no surcharge’ rules. If there is a case for regulator enforcement, it may be more efficient to target industries with high rates of over-surcharging, rather than introducing economy-wide regulation.
- **Provide merchants and customers with real-time pricing information regarding interchange fees and merchant service fees.** The CSR submission argues that this could enable customer surcharges to reflect costs accurately. Interchange service fees depend on a range of circumstances, including the payment system being used, the type of card being used (such as standard, gold or platinum) and the merchant receiving the payment. Currently, merchants can only estimate the average costs of acceptance. Accurate and transparent prices could allow clearer price signals and improve efficiency.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements
- Lower interchange fee caps or ban interchange fees
- Expand interchange fee caps to include payments of similar economic substance
- Remove interchange fee caps
- Cap merchant service fees or cap differences in interchange service fees between small and large merchants
- Require acquirers to enable merchants to choose which scheme to route transactions through
- Allow payment schemes to reintroduce ‘no surcharge’ rules or broaden the ban on ‘no surcharge’ rules to all payment systems
- Enforce reasonable cost recovery in customer surcharging
- Provide merchants and customers with real-time pricing information regarding interchange fees and merchant service fees

## Financial markets

Financial markets facilitate the operation of other financial sectors. The main activities in financial markets are typically split into three stages (Figure 2.2).

**Figure 2.2: The trade process**



- **Pre-trade** – an investor decides whether they wish to trade, what to trade and at what price.
- **Trade** – an investor that wishes to buy is connected to an investor willing to sell. A broker (or a dealer or a broker/dealer) generally assists in this process. For most financial products, the broker will use an exchange, an organised financial market where financial products are traded, but can also execute the trade directly with another broker.
- **Post-trade** – investors swap the financial product and cash. There are two main post-trade processes:
  - **Clearing** – details of the trade are confirmed and counterparties’ obligations calculated. In many markets, a central clearing facility, such as a central counterparty (CCP), will step in to manage the pre-settlement risks that exist between counterparties to a trade.
  - **Settlement** – the financial product is legally transferred to the buyer and the cash is transferred to the seller. A securities settlement facility provides for the final settlement of securities transactions. Settlement in most markets, such as cash equities, occurs quickly. However, derivatives markets are more complex due to the time taken for derivatives to terminate. CCPs manage the risks involved by requiring payment of collateral (called ‘margin’) as security. When derivatives expire, the final margin is paid to reflect the ending position of the contract.

In recent years, the Australian Government has taken steps to increase competition in financial markets. These steps include transferring supervision of Australia's equities markets to ASIC and otherwise amending regulatory arrangements to allow the entry of the Chi-X exchange in the equities trading market.

There is currently a Government moratorium on competition in clearing trades in Australian cash equities. This was implemented on the 2012 advice of the Council of Financial Regulators (CFR), which proposed it was not the appropriate time for further changes that would have additional cost implications for industry. The Australian Securities Exchange (ASX) has developed a code of conduct for access ahead of the CFR examining options for competition or access regulation in 2015.<sup>40</sup>

## Preliminary assessment

Stakeholders suggest that competition in financial markets is constrained in two areas:

- The time and resources required for market operators to obtain financial market licences, which can be a barrier to entry
- Cross-border operation of financial market infrastructure (FMI), including the moratorium on competition in clearing cash equities

Submissions also identify current licensing arrangements as a barrier to entry for foreign competitors.

## Financial market licensing

Generally, financial market operators in Australia must obtain an Australian Market Licence. The Minister can exempt a financial market from requiring a licence if ASIC advises there is no public benefit in regulating the market.

However, the current legislative system has not adapted to market developments. In its submission, Treasury notes that, as new market forms have arisen, the current legislative framework is producing a piecemeal approach to regulation. It is too inflexible to regulate all financial markets appropriately.

The piecemeal approach is reflected in the time taken to assess licence applications. Chi-X noted its licensing process took over three years. An earlier prospective entrant to operate a domestic equities market in Australia, AXE ECN, withdrew its proposal

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<sup>40</sup> ASX 2013, *Code of Practice for Clearing and Settlement of Cash Equities in Australia*, 9 August, ASX, Sydney.

four years after first applying for a licence.<sup>41</sup> This is slower than similar processes elsewhere. Exchange approval in the United Kingdom is subject to a six-month time limit. It took five months for BATS Chi-X to have its United Kingdom application to become a regulated stock exchange approved.

To some extent, the longer time for Australian applications may be attributable to the applications raising novel and complex regulatory issues. Introducing Chi-X required transferring responsibility for market supervision from ASX to ASIC and introducing a new regulatory and cost recovery framework.<sup>42</sup> Similarly, proposals by foreign clearers to offer services in Australian financial markets required regulators to consider cross-border service provision issues for the first time.

Future market entrants will benefit from the regulatory adjustments to accommodate initial applicants to these markets, but ‘level playing field’ issues remain. The initial applicants bear the cost and uncertainties that arise from seeking regulatory change. Some market innovations, such as crossing systems and dark pools, do not require financial market authorisation.

Treasury has commenced a review of the market licensing framework, which will consider how the framework may better accommodate market developments.

### Competition in financial market infrastructure

FMI competition can bring benefits through innovation and lower costs.<sup>43</sup> However, options to increase competition in FMI involve a trade-off between boosting efficiency, regulating functionally similar activities in the same way and giving Australian authorities capacity to regulate important FMI, especially in a crisis. Competition can be destabilising to existing market practices, but it can also remove single points of failure – potentially contributing to overall stability.

In its submission, ASX presents two potential long-term choices for Australia’s FMI:

- A domestic mandate for critical FMI, with all competitors required to comply with the same location and ownership requirements
- An open global market, with all participants, including ASX, free to optimise the economics of their arrangements

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41 This was a joint venture between New Zealand exchange operator, NZX, and six investment banks and brokerages, see: NZX 2010, *2010 Annual Financial Report*.

42 Bowen, C (Minister for Financial Services, Superannuation and Corporate Law) 2009, *Reforms to the supervision of Australia’s financial markets*, media release no. 013, 24 August, Canberra.

43 Council of Financial Regulators 2012, *Competition in Clearing Australian Cash Equities: Conclusions*, December.

Submissions from Chi-X and LCH.Clearnet support introducing competition for clearing for ASX-quoted securities when the moratorium expires, but did not comment on domestic location requirements.

However, a potential competitor is likely to offer a cheaper service if it can use existing infrastructure, which is typically located offshore. Requirements of scale and Australia's relatively small market mean that, in most cases, competition in FMI will come from foreign entrants, relying to some degree on cross-border infrastructure. Foreign entrants can also increase funding opportunities for domestic business.<sup>44</sup>

Chi-X suggests that a regulator, either ASIC or the ACCC, be given specific legislative responsibility for maintaining and supervising competition in Australia's FMI.

### *Guidance and recommendations from the Council of Financial Regulators*

To facilitate competition from international participants, the CFR has provided guidance of its expectations for international participation in Australia's FMI.<sup>45</sup> That guidance seeks to retain appropriate oversight, particularly for clearing and settlement facilities. Where FMI is systemically important and highly connected to domestic service provision, 'regulatory influence requirements' apply to ensure critical elements of infrastructure are located in Australia and subject to local regulation.

Further, the guidance imposes liquidity requirements on operators to ensure that, if a crisis occurs, a central counterparty, even one offering services from overseas, would have sufficient liquidity to meet its Australian obligations.<sup>46</sup> Foreign and domestic central counterparties will be required to manage their Australian dollar liquidity using an RBA Exchange Settlement Account. They must maintain sufficient assets in Australia, which would be eligible to enter into repurchase arrangements with the RBA to obtain liquidity. Other elements of the guidance address legal incorporation, governance arrangements and some location requirements for critical infrastructure.

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44 For example, see: Asian Development Bank 2008, *Emerging Asian Regionalism, Chapter 4: Integrating Financial Markets*, Philippines.

45 Council of Financial Regulators 2014, *Application of the Regulatory Influence Framework for Cross-border Central Counterparties*, March.

46 Heller, D and Vause, N 2012, 'Collateral requirements for mandatory central clearing of over-the-counter derivatives', *BIS Working Papers No 373*, March.

The CFR has also made recommendations to strengthen Australia’s FMI regulatory architecture and tools. This was done at the request of the Government following the rejection of the merger proposal between the ASX and the Singapore stock exchange.<sup>47</sup> The suggested reforms included:

- New powers to require systemically important market infrastructures to have aspects of their operations located in Australia, when the conditions set out in the CFR’s regulatory influence framework are met
- New powers to ensure FMIs are overseen by ‘fit and proper’ persons
- Increased power for regulators to intervene if infrastructure experiences substantial difficulties
- New resolution processes<sup>48</sup>

The Inquiry understands that CFR agencies have developed a set of legislative proposals to address these reforms.

Implementing the CFR recommendations for FMI and changes to market licensing would provide greater certainty to existing and future FMI operators. It would create a framework under which competition and international financial integration could be increased. The CFR proposals would also promote improved stability, as discussed in the *Stability* chapter.

## Wealth management

There is no clear definition of wealth management. For the purposes of this Inquiry, wealth management will be taken to include financial advice services and funds management. Superannuation is the largest component of the wealth management sector.

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<sup>47</sup> Council of Financial Regulators 2011, *Review of Financial Market Infrastructure Regulation: Consultation Paper*, October.

<sup>48</sup> Stevens, G 2012, *Review of Financial Market Infrastructure Regulation*, letter to the Deputy Prime Minister and Treasury, Reserve Bank of Australia, Sydney, 10 February, viewed 23 June 2014, <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/CFR-Financial-Market-Infrastructure-Regulation>>.

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The wealth management sector has undergone considerable consolidation since the Wallis Inquiry.

- The most successful platforms have been getting larger relative to their competitors. The five largest platform providers now hold almost 80 per cent of primary planner relationships.<sup>49</sup>
- Financial planners have consolidated or moved in-house to work directly for wealth management institutions.
- Vertical integration is increasing, with the major banks and AMP at the forefront of this trend, combining advice, platforms and fund management into single businesses. Other wealth managers, including Macquarie Group, IOOF and Perpetual, have replicated this strategy to varying degrees.

Competition in the wealth management sector appears to be focused more on securing distribution channels and improving product features, rather than reducing fees. The *Superannuation* chapter explores competition issues in relation to superannuation products and the recent MySuper reforms. The *Consumer outcomes* chapter discusses the recent Future of Financial Advice (FOFA) reforms; however, it is too early to assess the effect of these reforms on competition.

The Inquiry welcomes stakeholder views on competition issues in the broader wealth management sector.

## Insurance sector

The insurance market is segmented between general insurance, comprising personal and commercial lines, and life insurance, comprising risk products (death, disability and income protection) and investment products. There is also a reinsurance market: the insurers of the insurers.

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<sup>49</sup> Investment Trends 2014, *Planner Technology Report*, May. Note: Based on a survey of 1,038 financial planners.

## Preliminary assessment

The insurance sector has similar levels of concentration and profitability to the banking sector.

- The personal lines market for **general insurance** is concentrated. The top five insurers account for over 80 per cent of the market,<sup>50</sup> with the top two estimated to have a 60 per cent share.<sup>51</sup>
- There is less market concentration in **commercial insurance**, where the five largest insurers have about 60 per cent market share of gross earned premium.<sup>52</sup>
- The **life insurance** industry is more fragmented than the general insurance industry, although several of the major insurers are owned by banks.

Although the sector has generally become more concentrated, some trends are moving in the opposite direction. For example, a number of new insurers have entered the market, including Youi, Hollard and Progressive. Banks and retailers have also entered the insurance market, usually by white labelling products provided by the main insurers, but with some underwriting themselves.

Returns on equity in insurance have been more volatile than in the banking sector. For general insurance, they have averaged 16.5 per cent since 2002 and around 13.5 per cent since the GFC.<sup>53</sup> For life insurance, returns have averaged around 14 per cent since the GFC, although they fell to below 10 per cent in 2013 due to higher than expected disability claims and lapse rates on individual policies.<sup>54</sup>

As with banking, the main barriers to entry in insurance are commercial rather than regulatory. Incumbents benefit from well-established brands, customer bases and distribution networks. These advantages are particularly important in the direct marketed sectors, although annual renewal requirements in general insurance provide a trigger for switching that is not evident in many banking products.

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50 Australian Prudential Regulation Authority 2014, First round submission to the Financial System Inquiry.

51 UBS 2014, *Australian Insurance Sector Update, Reality Check*, UBS, 14 May.

52 Australian Prudential Regulation Authority 2014, First round submission to the Financial System Inquiry.

53 Australian Prudential Regulation Authority (APRA) 2014, *Quarterly General Insurance Performance Statistics*, APRA, Sydney, March 2014.

54 Australian Prudential Regulation Authority (APRA) 2014, *Quarterly Life Insurance Performance Statistics*, APRA, Sydney, March 2014.

Despite the high level of concentration, few submissions raise concerns about competition in the insurance sector.

### Aggregator access to information

The main issue submissions raise in relation to insurance sector competition relates to aggregator access to information. Insurers in the home and contents and car insurance markets have been reluctant to share their product information with aggregators, slowing their growth. As a result, consumers in these markets must compare products without the assistance of aggregators, which may reduce price competition.

However, insurers argue that it is more complex to aggregate insurance products than other financial products, because they are tailored to individual circumstances. In addition, aggregators need access to insurers' pricing models, or at least the outcomes they provide, to compare different product offerings. If this access was provided, it could potentially enable aggregators or other market participants to identify sensitive pricing information, such as premia differentials based on market research. Some stakeholders are also concerned that aggregator services could lead to consumers focusing too much on price and potentially underinsuring.

However, these concerns have not prevented aggregators from successfully assisting consumers to compare products in the life insurance, travel insurance and private health insurance markets. Therefore, there may be scope to improve aggregator access to general insurance product information.

### Competition for statutory insurance schemes

Submissions from insurers and insurance brokers note that some state- and territory-based statutory insurance schemes are not open to private sector competition. The two main types of statutory schemes are workers compensation and personal injury motor accidents schemes. Submissions argue that some schemes operate like government monopolies and that consumer value could be improved by introducing competition from the private sector. The Inquiry notes that stakeholders have also raised these concerns with the Competition Policy Review. The Inquiry would welcome stakeholder views on this matter.

## Policy options for consultation

### Aggregator access to information

One option to enhance aggregator access to general insurance product information is to ensure aggregators are able to use automated processes to seek quotes from general insurance websites. This would not give aggregators direct access to pricing models, but may provide a route to discover them.

Another option could be to develop representative consumer categories based on key consumer characteristics. Insurers could disclose their policy premia for each category and consumers could then, potentially with the assistance of aggregator services, compare premiums from different insurers for the category that best represents their characteristics. The difficulty with this option would be developing enough categories so the majority of consumers fall within a category, while not creating too many categories, which could create complexity for consumers and compliance costs for insurers.

An issue with both of these approaches is that different insurance policies generally have different levels of coverage. Even if consumers are able to compare the premia of different policies, they may still struggle to compare coverage and overall value. The Inquiry welcomes input on how these issues could be managed.

*The Inquiry would value views on the costs, benefits and trade-offs of the following alternatives:*

- No change to current arrangements
- Ensure aggregators are able to use automated processes to seek quotes from general insurance websites
- Create comparison categories for insurance products that aggregators could use to compare the value of different products

*The Inquiry seeks further information on the following areas:*

- Would opening up state- and territory-based statutory insurance schemes to competition improve value for consumers?
- How could insurance aggregators provide meaningful comparisons of policies with different levels of coverage?



## 3: Funding

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The Inquiry has been asked to examine how the Australian financial system allocates funding and risk to maximise growth opportunities for the Australian economy.

By allocating funding and risk efficiently, the financial system can promote higher productivity growth. Transparent and accurate pricing of risk ensures that risks can be distributed to entities that are willing and able to bear those risks.

The Inquiry has made the following observations about the allocation of funding and risk in the Australian economy:

- Ongoing access to foreign funding has enabled Australia to sustain higher growth than otherwise would have been the case. The risks associated with Australia’s use of foreign funding can be mitigated by having a prudent supervisory and regulatory regime and sound public sector finances.
- There are structural impediments for small- and medium-sized enterprises (SMEs) to access finance. These impediments include information asymmetries, regulation and taxation.
- Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development.

The Inquiry has identified a number of tax issues that affect the allocation of funding and risk in the economy. Those issues that are not currently under active Government consideration should be considered as part of the Tax White Paper process.

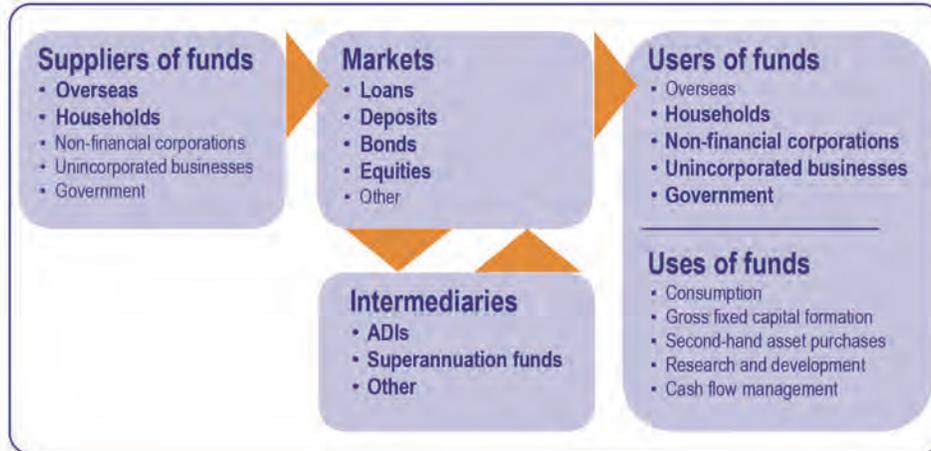
### Context

The financial system’s ability to allocate funding and risk efficiently is central to promoting a higher trend rate of economic growth. The financial system does this by: providing funding for business investment and innovation; enabling businesses, households and governments to smooth their cash flows and make large asset purchases; and facilitating the transfer of risk to give agents greater certainty to undertake certain economic activities.

Figure 3.1 shows a high-level representation of the supply and use of funds in the economy. Suppliers of funds provide savings to users of funds through markets and

intermediaries. This chapter deals explicitly with the components in Figure 3.1 in bold type. They represent major issues raised in submissions to the Inquiry.

**Figure 3.1: The supply and use of funds in the economy**



## Assessing allocative efficiency

It is difficult to assess and quantify the effect any inefficient allocation of funding and risk has had, and is having, on economic growth. It is also difficult to identify what an efficient allocation of funding would look like. The best way to ensure resources are allocated efficiently is to allow relative prices to perform their allocative function. The Campbell Inquiry placed particular emphasis on this mechanism to facilitate a better allocation of funding and risk in the economy; this Inquiry sees no reason to change this emphasis.

The Inquiry has examined potential impediments to prices performing their primary function and has identified three main sources of distortions: taxation, regulation and other market imperfections. The Inquiry has explored these distortions by examining the saving, investment and funding choices of households, businesses, governments and financial entities, and the functioning of certain financial markets.

The Inquiry has identified a number of taxes that may distort the demand for and supply of funding in particular sectors, and may distort the broader allocation of funding and risk. This chapter explores these issues in more detail. The Inquiry has also identified other taxes that may adversely affect outcomes in the broader financial system. A summary of these tax issues is in *Appendix 2 (Tax summary)*. Those issues that are not currently under active Government consideration should be considered as part of the Tax White Paper process.

## Funding from overseas

Australia has recorded current account deficits for most of its post-European settlement history. Over the past two decades, Australia's current account deficit has averaged roughly 4½ per cent of GDP. However, Australia's gross cross-border financial flows are larger: inflows of foreign funds have averaged around 8½ per cent of GDP over the past two decades, while outflows of Australian investment abroad have been around 4¼ per cent of GDP on average over the same period.

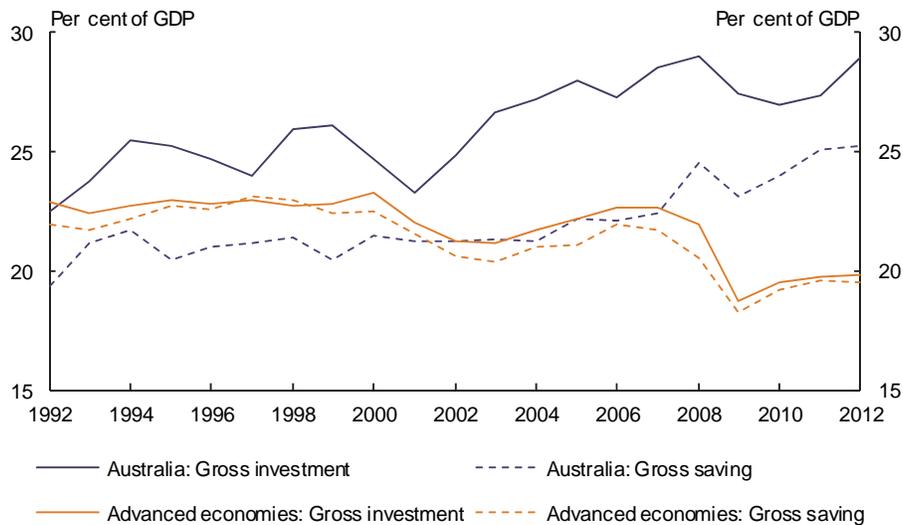
## Australia's open capital account

### *Observation*

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

Australia typically has had more abundant domestic investment opportunities than could possibly be funded from historic levels of national saving, and has therefore recorded persistent current account deficits. Compared to other advanced economies, Australia has had a relatively high investment rate and, more recently, a comparatively high saving rate (Chart 3.1). By using foreign funds productively, Australia's growth potential can be raised to benefit both residents and foreign investors.

**Chart 3.1: Gross saving and gross investment for Australia and for advanced economies<sup>1</sup>**



Source: IMF.<sup>2</sup>

Access to offshore markets (reflected in gross inflows) frees Australian borrowers from domestic financing constraints. Foreign investors may not have the same risk-return preferences as their Australian counterparts, so access to foreign funding markets may enable Australian borrowers to align their funding needs better with investors' preferences. All else being equal, this would tend to enhance Australian borrowers' ability to raise funds and lower the cost of those funds. This helps support a higher level of gross fixed capital formation and a higher rate of labour productivity growth.

Investing offshore allows Australians to achieve a more diversified investment portfolio internationally on the basis of expected returns and risks. It also means that Australian entities compete for finance in global funding markets, which has broader productivity benefits.

The continued inflow of foreign funding reflects the confidence foreigners have in both Australia's growth prospects, and Australia's capacity and willingness to service and repay its foreign liabilities.

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1 Gross saving and gross investment reflect total saving and total investment (the aggregate of all sectors).  
 2 International Monetary Fund (IMF) 2014, *World Economic Outlook Database*, IMF, Washington DC, United States.

## The risks of using foreign funding

The risks to Australia, and to the financial system, from foreign funding relate more to rollover risk on debt than to foreign currency risk.<sup>3</sup> Around two-thirds of Australia's gross foreign liabilities are in the form of debt. Australia is therefore exposed to the risk that foreign debtors may choose to withdraw funding when the debt matures, particularly during periods of financial stress.<sup>4</sup> The shorter the term of the debt, the more acute the rollover risk.

Since the global financial crisis (GFC), rollover risk has receded. Although banks still hold the bulk of Australia's short-term foreign debt liabilities, these now represent a lower share of banks' foreign debt liabilities than before the crisis.<sup>5</sup>

If foreigners become reluctant to invest in Australia, the cost of funding (for both debt and equity) for Australian entities would increase significantly. The higher cost of funding would translate into lower growth in gross fixed capital formation and GDP.

As a significant net importer of funds, Australia needs to maintain the confidence of foreign investors to ensure ongoing cheap access to foreign funds. To do this, it should adhere to the following principles:

- Use foreign funds productively.
- Maintain a prudent supervisory and regulatory regime for the broader financial system.

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3 As at the end of March 2013, about 70 per cent of Australia's gross foreign liabilities were denominated in Australian dollars. In addition, about a further 20 per cent of Australia's gross foreign liabilities were hedged into Australian dollars (this does not account for 'natural hedges'). Australia as a whole has a net foreign currency asset position – that is, the stock of Australia's foreign currency assets is larger than the stock of Australia's foreign currency liabilities (as such, a depreciation of the Australian dollar, all else being equal, would reduce the size of Australia's net foreign liabilities). Reserve Bank of Australia (RBA) 2013, 'Foreign Currency Exposure and Hedging in Australia', *RBA Bulletin*, December Quarter, RBA, Sydney, page 51.

4 As at the end of March 2014, Australia's total gross foreign liabilities were \$2.5 trillion, \$0.9 trillion of which was equity (or 35 per cent). Australian Bureau of Statistics (ABS) 2014, *Balance of Payments and International Investment Position*, cat. no. 5302.0, ABS, Canberra.

5 For the main categories of foreign debt liabilities (debt securities, currency and deposits, and loans), deposit-taking institutions account for around 90 per cent of foreign debt liabilities that are short term (as at the end of March 2014). For deposit-taking institutions, their short-term foreign debt liabilities (with respect to debt securities, currency and deposits, and loans) have decreased as a share of their foreign debt liabilities (debt securities, currency and deposits, and loans), from 43 per cent in the September quarter 2008 to 28 per cent in the March quarter 2014. Australian Bureau of Statistics (ABS) 2014, *Balance of Payments and International Investment Position*, cat. no. 5302.0, ABS, Canberra.

- Run a strong general government balance sheet to ensure governments remain good credit risks. In the event of a significant economic and financial disruption, more sustainable fiscal settings would provide the Government with greater capacity to support the economy and the financial system. Outside periods of stress, the Government's credit rating is reflected in private sector ratings and therefore affects the cost of and access to foreign funds for the private sector.

## Household saving

Households save through purchasing assets and paying down debt. Superannuation is the largest (and fastest growing) financial asset on the household balance sheet, followed by deposits and equities. Housing is a significant savings vehicle for households, but also represents a significant use of funds in the economy. The *Housing and household leverage* section in this chapter explores this issue in further detail.

## Taxation and the household balance sheet

The unequal tax treatment of savings vehicles distorts the asset composition of household balance sheets. This can affect the broader flow of funds in the economy. Many submissions support a more uniform tax treatment of household savings.<sup>6</sup>

Decisions related to asset allocation are based on the after-tax return and risk characteristics of different savings vehicles. The extent to which tax distorts relative after-tax returns affects both the composition of household assets and the amount of risk households are prepared to accept. *Australia's Future Tax System Review* noted that:

*There is considerable evidence that tax differences have large effects on which assets a household's savings are invested in. Based on an examination of the literature and OECD data, the OECD concluded that while low-income individuals respond to tax incentives with more savings, for high-income individuals in particular savings are diverted from taxable to tax-preferred savings.<sup>7</sup>*

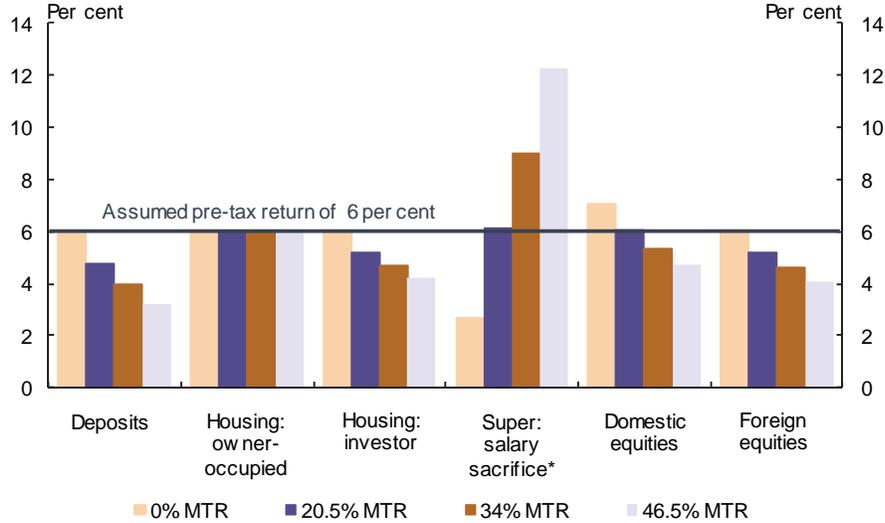
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6 For example, Westpac 2014, First round submission to the Financial System Inquiry, page 48.

7 Commonwealth of Australia 2009, *Australia's Future Tax System Review: Report to the Treasurer, Part Two – Detailed analysis, volume 1 of 2*, Commonwealth of Australia, Canberra, page 68.

**Chart 3.2: Stylised example – after-tax return on savings vehicles<sup>8, 9, 10</sup>**

For individuals on different marginal tax rates, no leverage



\*For salary-sacrificed superannuation, the chart depicts individuals whose contributions do not exceed the prescribed contribution caps. For individuals earning income for surcharge purposes above \$300,000, contributions may be subject to an additional 15 per cent tax, which reduces the superannuation concession. For individuals on the top marginal tax rate subject to this additional tax, the after-tax return would be 9.2 per cent.  
Source: Treasury.

Across savings vehicles, after-tax returns differ markedly in the stylised example presented in Chart 3.2. For most savings vehicles, taxation reduces the after-tax return. However, in some cases – particularly salary-sacrificed superannuation for higher income earners – taxation increases the after-tax return above the pre-tax return.

Of the savings vehicles depicted, bank deposits (and other interest-earning assets) are taxed relatively heavily because the interest earned on deposits is subject to the individuals' marginal tax rate.

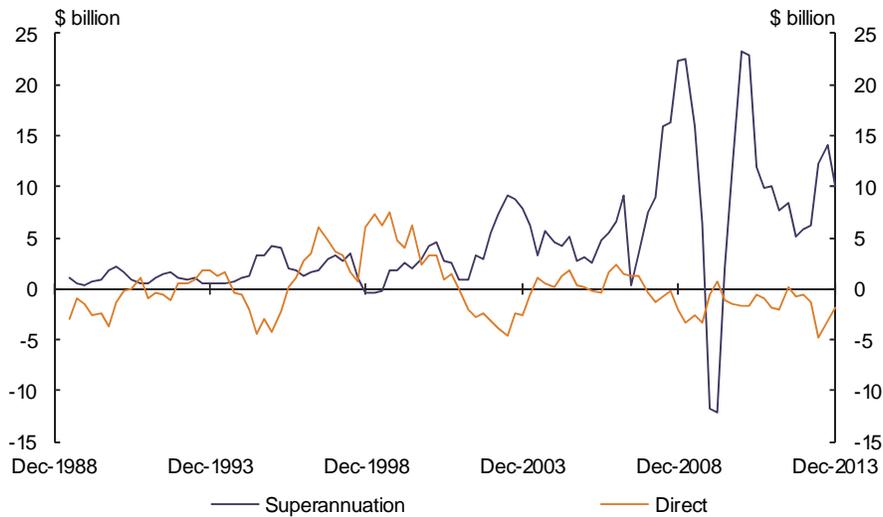
- 
- 8 Chart 3.2 shows the nominal post-tax return for a range of savings vehicles, assuming a pre-tax nominal return (for each savings vehicle) of 6 per cent per annum. The analysis assumes that the assets are held for seven years. The chart draws on methodology used in *Australia's Future Tax System Review: Report to the Treasurer Part Two – Detailed analysis, volume 1 of 2*, page 67. The marginal tax rates reflect the individual income tax thresholds plus the 1.5 per cent Medicare levy but excludes the Temporary Budget Repair levy and the recent increase in the Medicare levy.
  - 9 Chart 3.2 shows the tax treatment of salary-sacrificed superannuation. The tax advantages for non-concessional contributions, which comprise the majority of superannuation fund assets, are less generous than for salary-sacrificed superannuation.
  - 10 The relative tax treatment of assets is the same within superannuation as outside superannuation.

In general, returns on salary-sacrificed superannuation are either taxed concessionaly or subsidised, except for very low-income earners. Salary-sacrificed superannuation contributions are taxed at a flat rate of 15 per cent, rather than the individual’s marginal rate – unless contributions exceed prescribed caps. Individuals with income, including contributions, above \$300,000 may pay additional tax on contributions that reduce the attractiveness of salary-sacrificed superannuation.

For assets that generate capital gains, the asymmetric tax treatment of borrowing costs to purchase assets (and other expenses) and capital gains can result in a tax subsidy by raising the after-tax return above the pre-tax return. Individuals can deduct their full interest costs (and other expenses) from taxable income, but only half of capital gains are taxed when they are realised at a time chosen by the taxpayer. All else being equal, the increase in the after-tax return is larger for individuals on higher marginal tax rates.

The tax system encourages households to direct their savings into superannuation funds. Households’ allocation of assets towards superannuation as a preferred savings vehicle is reflected in their holdings of other assets. For example, since around 2002, households have tended to reduce their direct holdings of equities, instead opting to invest in equities through superannuation (Chart 3.3). This has been facilitated by changes to capital gains tax arrangements in 1999, which lowered the tax costs of selling equities and other assets.

**Chart 3.3: Household investment in domestic equities (transactions, four-quarter moving average)**



Source: ABS.<sup>11</sup>

11 Australian Bureau of Statistics (ABS) 2014, *Balance of Payments and International Investment Position*, cat. no. 5302.0, ABS, Canberra.

The distortions generated by the tax system affect the channels by which savings are allocated to the users of funds. This is particularly relevant to the superannuation sector, which is expected to grow rapidly over coming decades. *The banking system* and *Superannuation* sections in this chapter explore these issues further.

Households' exposure to adverse market movements depends on the mix of savings vehicles; for example, if households choose to invest in a superannuation fund regulated by the Australian Prudential Regulation Authority (APRA) rather than in other savings vehicles. The asset allocations of APRA-regulated superannuation funds are more diversified than the asset allocations of self-managed superannuation funds (SMSFs) and the household balance sheet (excluding superannuation) (Chart 3.9). To some extent, SMSFs' asset allocations also reflect the age composition, and thus particular investment preferences, of individuals within SMSFs. The *Superannuation* section in this chapter explores this issue in further detail.

## Housing and household leverage

Housing accounts for the largest share of household assets. It serves two important functions for households: acting as a store of wealth, and producing a flow of housing services that households consume.

Since 1997, household leverage has increased markedly from debt equivalent to around 0.8 years of gross disposable income to around 1.5 years of income in 2008 – household leverage has since stabilised at around this level.<sup>12</sup> Australia's trajectory and current level of household leverage is similar to that in some other advanced economies.<sup>13</sup>

Since the Wallis Inquiry, over 90 per cent of the increase in household credit has been due to borrowing for housing; investor housing credit has accounted for one-third of the increase in total housing credit over this period.<sup>14</sup>

## Housing finance

There is little evidence of a shortage of housing finance. Although lending conditions tightened following the GFC, this only partially reversed the easing of lending

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12 The ratio of household debt to annualised household disposable income. Reserve Bank of Australia (RBA) 2014, *Statistical Tables: Household Finances – Selected Ratios (E2)*, RBA, Sydney.

13 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 32.

14 Reserve Bank of Australia (RBA) 2014, *Statistical Tables: Money and Credit Statistics, Lending and Credit Aggregates (D2)*, RBA, Sydney.

conditions that occurred over the preceding couple of decades. Over that period, product innovation increased the range of, and households' access to, loan products. In general, households are not constrained from borrowing amounts that they can reasonably be expected to repay.<sup>15</sup>

Demand for housing finance largely reflects purchases of existing (rather than new) housing by households wanting to upgrade or downgrade, by first home-buyers or by investors.

Since 1997, around 10 per cent of the flow of housing finance has been for constructing new dwellings.<sup>16</sup> New dwelling construction arguably has not been sufficient to meet population growth over the past decade.<sup>17</sup> The Australian housing market has a number of longstanding structural features that inhibit supply responsiveness to demand-driven price rises. These include regulatory and zoning constraints, inherent geographical barriers and the cost structure of the building industry.<sup>18</sup> These issues are out of the scope of this Inquiry.

The increase in housing debt over recent decades has been facilitated by households' capacity and willingness to borrow. Growth in household incomes has allowed households to service larger loans for a given interest rate. Australia's move to a low-inflation and low-interest rate environment facilitated a one-off shift in the level of household debt. To some extent, households' greater capacity to borrow has contributed to the increase in housing prices relative to income since 2000.

## Taxation and regulatory treatment of housing

Households' appetite for housing debt also reflects the favourable treatment that the tax and transfer system applies to housing. Returns on owner-occupied housing (including imputed rent and capital gains) are exempt from tax, although this is not unusual by international standards. This makes housing a very attractive vehicle for saving. In addition to the more favourable tax treatment, individuals have an extra incentive to put more of their wealth into their primary residence because of the means test for the Age Pension, which excludes the primary home. This leads to higher allocation of wealth to housing and, for some, an inefficient level of consumption of housing services.

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15 Reserve Bank of Australia 2014, *Submission to the Inquiry into Affordable Housing*, Senate Economics References Committee, Sydney, page 1.

16 Reserve Bank of Australia (RBA) 2014, *Statistical Tables: Money and Credit Statistics, Lending Commitments – All Lenders (D6)*, RBA, Sydney.

17 National Housing Supply Council (NHSC) 2012, *Housing Supply and Affordability – Key Indicators*, NHSC, Canberra, page 25.

18 Reserve Bank of Australia 2014, *Submission to the Inquiry into Affordable Housing*, Senate Economics References Committee, Sydney, page 1.

The tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment in housing. Investors are attracted by the asymmetry in the tax treatment of expenses and capital gains on investor housing. Investors can reduce their tax liabilities by deducting borrowing costs and other related expenses against total income at the individual's full marginal tax rate.<sup>19</sup> However, nominal capital gains, when realised, are effectively taxed at half the marginal rate.

This regime has been in place since 1999; between 1985 and 1999, real capital gains were taxed at the individual's full marginal tax rate.<sup>20, 21</sup> The change in capital gains tax arrangements reduced the tax burden of holding an investment property for shorter periods and has contributed to the growth in investor housing credit and investors' shift to more leveraged investments over the past 15 years (Charts 3.4 and 3.5). Because of these tax arrangements, owners of residential property have an incentive to repay their mortgage as slowly as possible to maximise the tax deductions they can accrue. Loans with interest-free periods help to maximise these tax deductions in the early years of a loan, although these loans also give borrowers more flexibility with repayments. The tax system, therefore, encourages individuals to take on more risk, which does have implications for risks to lenders.

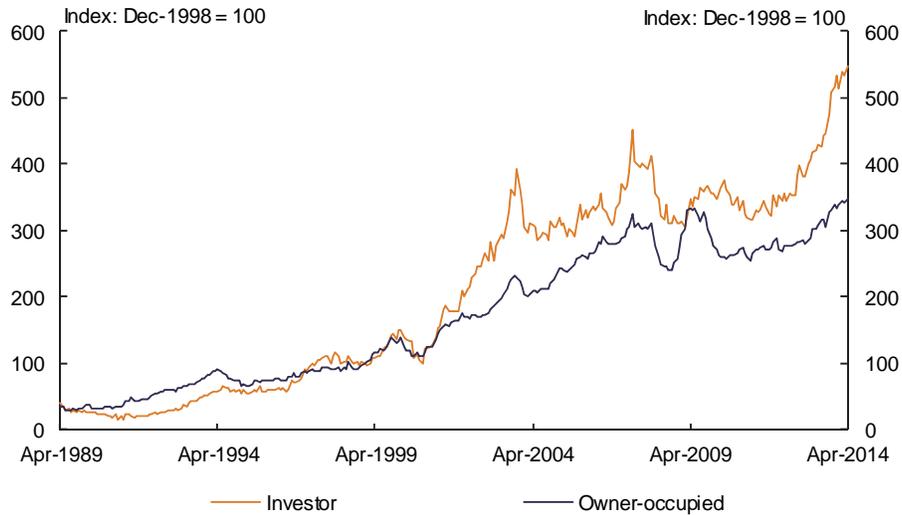
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19 Against total income, not only income from the property.

20 On investments held for more than 12 months.

21 At an average rate of inflation of 3 per cent, a property would need to be held for 66 years under pre-1999 tax concessions to get the same capital gains tax concession as the current arrangements provide after holding the property for one year.

**Chart 3.4: Housing finance (flow of housing lending commitments)**



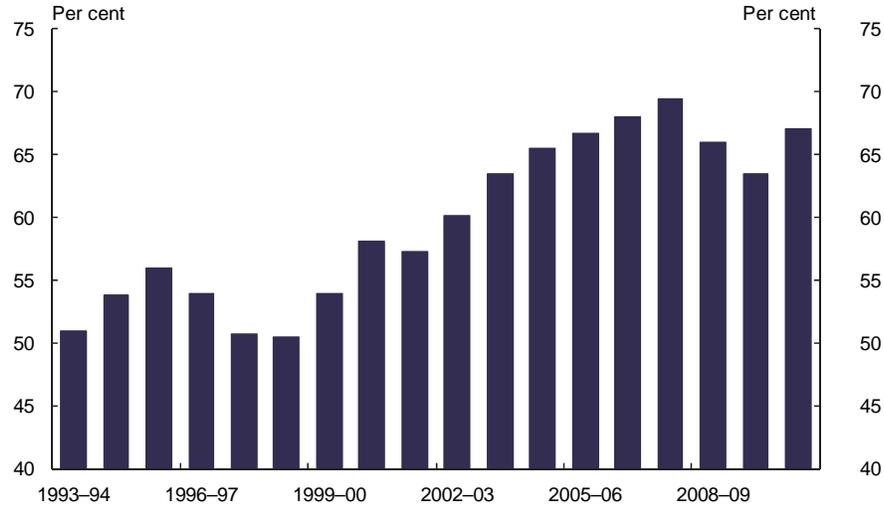
Source: RBA.<sup>22</sup>

Although these tax arrangements apply to other leveraged investments, such as equities, investors perceive housing investment as less risky than leveraged securities investment; mortgages are less likely to be subject to margin calls, and there is arguably a widespread and falsely held view that housing prices never fall.<sup>23</sup>

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22 Reserve Bank of Australia (RBA) 2014, *Statistical Tables, Money and Credit Statistics, Lending Commitments – All Lenders (D6)*, RBA, Sydney.

23 Glenn Stevens has noted that “It is a very dangerous idea to think that dwelling prices cannot fall. They can, and they have.” Stevens, G (Governor of the Reserve Bank of Australia) 2012, *The Lucky Country*, address to The Anika Foundation Luncheon, 24 July, Sydney.

Chart 3.5: Proportion of landlords with net losses<sup>24</sup>

Source: ATO.<sup>25</sup>

Some submissions argue that the current risk-weighting arrangements favour housing loans, or loans secured by housing, at the expense of business loans. Since the current risk-weighting scheme was introduced in 2008, the share of credit used for housing has increased. However, this has been the trend for the past 20 years or so.<sup>26</sup> In addition to this trend, the GFC weighed on business conditions and investment, which reduced business demand for credit. As conditions improved, low market interest rates made the bond market a relatively attractive source of funds compared to bank loans, particularly given the more favourable covenants on bonds compared to bank loans.

## The broader effects and risks associated with housing and household leverage

One implication of higher household debt is the extent to which housing finance may crowd out finance for other activities. The banking system generally does not face binding constraints on balance sheet growth from prudential requirements. However, at times, lending by individual institutions may be constrained by such requirements. In addition, banks may choose to restrict lending, overall or to specific sectors, to manage their exposures.

<sup>24</sup> Net rent equals gross rent less rental deductions, which include interest, capital works and other deductions.

<sup>25</sup> Australian Taxation Office (ATO) 2012, *Taxation Statistics 2011-12*, ATO, Canberra.

<sup>26</sup> Reserve Bank of Australia (RBA) 2014, *Statistical Tables: Money and Credit Statistics, Lending and Credit Aggregates (D2)*, RBA, Sydney.

In an environment of rising house prices, such constraints may see bank allocate funds towards housing and away from (unsecured) business loans.<sup>27</sup> All else being equal, this would tend to increase the price and reduce the amount of business lending.<sup>28</sup> Cross-country analysis on the effects of bank credit on economic growth suggests that credit provided to businesses has a larger positive effect on growth than credit provided to households.<sup>29</sup>

Housing is also a potential source of systemic risk for the financial system and the economy. Since the Wallis Inquiry, the increase in households' mortgage indebtedness has been accompanied by banks allocating a greater proportion of their loan book to mortgages; the share of loans for housing has increased from 47 per cent in 1997 to its current share of 66 per cent. A large enough disruption to the housing market could have significant implications for household balance sheets, financial stability, economic growth, and the speed of recovery in household spending and broader economic activity following a shock.

As discussed in the *Stability* chapter, the FSI Secretariat conducted an analysis of a number of scenarios (Box 5.3). One of the scenarios considered the effect of a shock that resulted in a sharp and prolonged fall in house prices. In this scenario, household wealth would contract and there would be broader and, potentially, long-lasting effects on the economy and financial system. A sharp fall in house prices could push some households into negative equity and would amplify financial distress associated with any broader economic downturn. Deleveraging, combined with lower consumer confidence, would weigh on household consumption and broader economic growth. The extent of the damage to households' balance sheets would determine, to a large degree, the speed of recovery of household consumption.

An extreme shock of this nature would also affect the quality of banks' balance sheets and their capacity to extend new credit. This would include business lending, particularly for small businesses – which tend to use housing as collateral. Offshore wholesale funding would be likely to become more expensive and some banks might find it more difficult to raise funds, which would exacerbate pressures on the cost and availability of bank credit. Overall, the deterioration in bank balance sheets would compromise the speed of a subsequent recovery in economic activity.

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27 APRA imposes constraints, in particular by requiring banks to meet certain ratios with respect to capital relative to risk-weighted assets. Banks face internal constraints from desired returns on equity.

28 Chakraborty, I, Goldstein, I, and MacKinlay, A 2013, 'Dark side of housing-price appreciation', *VOX*, 25 November.

29 Beck, T, Buyukkarabacak, B, Rioja, F K and Valev, N T 2012, 'Who gets the credit? And does it matter? Household vs. firm lending across countries', *The B.E. Journal of Macroeconomics*, issue 1, vol 12, De Gruyter, United States.

How policy would react to these developments – to boost demand or stabilise the financial system – would depend on the capacity of Government to use available tools to respond. The strength of the Australian Government balance sheet and the level of interest rates would affect the degree to which both fiscal and monetary policy could provide support for the economy.

It is difficult to quantify the likelihood of such a scenario occurring in Australia. Official stress test results in recent years have found Australian banks are likely to be relatively resilient to most shocks. Historically, banks have mainly realised losses on their commercial property loan portfolios. However, the exposure of the financial system to the housing market has clearly increased over time and, in the opinion of the Inquiry, the systemic risk associated with this trend should be further considered.

*The Inquiry seeks further information on the following area:*

What measures can be taken to mitigate the effects of developments in the housing market on the financial system and the economy? How might these measures be implemented and what practical issues would need to be considered?

## Corporate financing

Non-financial corporations source funds internally from retained earnings and externally from lenders and from financial markets.

Corporations decide on a mix of debt and equity that minimises their cost of capital while maintaining a favourable credit rating. Financing decisions also reflect particular preferences for internal over external financing, the particular activities that corporates undertake, and the timing of any fund raising. Risk preferences matter as well. Corporates have to consider the risk that debt providers might not roll over debt when it matures or any triggers in debt contracts requiring early repayment. Depending on the nature of coupon payments on debt, corporates may need to consider the risk that interest rates might increase. Australia's corporate tax regime also affects corporates' choice of financing.

Given that access to different types of funding also matters, issues relating to the domestic corporate bond and equity markets are explored elsewhere in this chapter.

## Tax treatment of corporate financing

In Australia, as is the case in tax systems across the world, debt costs are tax deductible. Equity-financed investments are subject to corporate tax, although Australia's dividend imputation regime reduces, to some degree, the after-tax cost of equity.

## Dividend imputation

Some submissions raise the need to review Australia's dividend imputation regime. Submissions note the effect of imputation on investor and corporate behaviour, but they also recognise the potentially complex consequences of any changes to the corporate tax regime on such behaviour and the broader flow of funds. In its submission, PwC states:

*[C]areful consideration should be given to whether there would be benefits to be obtained from modifications to the imputation system.<sup>30</sup>*

In 1987, Australia introduced dividend imputation to remove the bias against domestic equity (because of the pre-existing double taxation of corporate earnings) and to increase investment. However, the case for retaining imputation is now less clear than it was in the past.

The dividend imputation system affects corporate funding decisions in two main ways: the amount of debt financing to seek, and the share of earnings to distribute to shareholders, which affects the amount of equity financing used.

By removing the double taxation of corporate earnings, the introduction of dividend imputation reduced the cost of equity and so contributed to the general decline in leverage among non-financial corporates. Relative to corporates in other jurisdictions, Australian corporates generally have lower leverage.<sup>31</sup> In general, this makes Australia's corporate sector more resilient to shocks and means that such shocks are less likely to have systemic implications. When reflecting on the lessons of the GFC, the International Monetary Fund (IMF) stated:

*In most countries, the tax system is biased toward debt financing through deductibility of interest payments. This bias to higher leverage increases the vulnerability of the private sector to shocks, and should be eliminated.<sup>32</sup>*

Corporates' dividend policies are influenced by demand from shareholders for dividends and demand from domestic shareholders for the franking credits associated with imputation (as well as corporates' capital funding and cash flow requirements). This encourages firms to pay a greater proportion of their earnings as dividends. Arguably, this subjects corporates to more market discipline by requiring them to raise more external funds (debt or equity) to fund new investment projects.

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30 PwC 2014, First round submission to the Financial System Inquiry, page 76.

31 Fan, J P H, Titman, S and Twite, G 2012, 'An International Comparison of Capital Structure and Debt Maturity Choices', *Journal of Financial and Quantitative Analysis*, issue 1, vol 47, University of Washington, Seattle, pages 23–56.

32 International Monetary Fund (IMF) 2009, *Lessons of the Global Crisis for Macroeconomic Policy*, 19 February, page 14.

*Australia's Future Tax System Review* argued that the benefits of dividend imputation, particularly in lowering the cost of capital, have declined as Australia's economy has become more open. If, as some argue, global capital markets set the (risk-adjusted) cost of funding, dividend imputation acts as a subsidy to domestic equity holders but does not affect the cost of capital or the level of investment. The effect of dividend imputation is to increase private saving and reduce the use of foreign funding for investment.<sup>33</sup>

The degree to which dividend imputation may act as a subsidy to domestic equity, making equities relatively more attractive as a savings vehicle, may contribute to a number of characteristics of the broader financial system. These include:

- The propensity of domestic investors, particularly superannuation funds, to hold more domestic equity relative to foreign equity and other asset classes than otherwise would be the case, which encourages less diversified portfolios
- The lack of a deep, liquid domestic corporate bond market
- Low demand for annuities, which are largely supported by fixed-income securities, relative to a retirement income strategy based on high-yield domestic equity

## Small- and medium-sized enterprises

SMEs are major employers and drivers of economic growth. Australia's 2 million SMEs employ almost 70 per cent of the workforce, which is large by international standards.<sup>34</sup> <sup>35</sup> SMEs account for over half of the output of the private sector and tend to be a major source of innovation in the economy.

Small business entrepreneurs will often use their families' finances to fund their business. Some seek external funding, which can include extra equity or debt from family and friends, debt from financial institutions, or equity from venture capital funds. Banks' business models and expertise are more suited to providing debt finance to established businesses, whereas venture capital is more suited to start-up firms in nascent industries.

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33 Commonwealth of Australia 2009, *Australia's Future Tax System Review: Report to the Treasurer, Part Two – Detailed analysis, volume 1 of 2*, Canberra, pages 191–98.

34 This reflects ABS categories. Australian Bureau of Statistics (ABS) 2013, *Counts of Australian businesses, including entries and exits*, cat. no. 8165.0, ABS, Canberra.

35 This reflects ABS categories. Australian Bureau of Statistics (ABS) 2013, *Australian Industry*, cat. no. 8155.0, ABS, Canberra.

## Financing conditions for small and medium enterprises

### Cost

Interest rates on SME loans are generally higher than those for large business loans and mortgages.

This largely reflects the higher costs and risks associated with bank lending to SMEs. Smaller businesses typically have less documentation and shorter financial histories, so it is generally harder and more costly for banks to acquire the required information to make accurate credit assessments. In addition, SMEs typically have more volatile revenue streams and are more likely to default. As such, lenders generally make higher provisions for loan losses than for larger corporates. However, lenders do differentiate on price and some businesses can pay below standard rates, depending on their credit history and quality of collateral.

Since the GFC, interest rate spreads on small business loans have increased relative to other loan types, which reflects the generally higher price of risk (Chart 3.6). This is similar to developments in some other advanced economies.

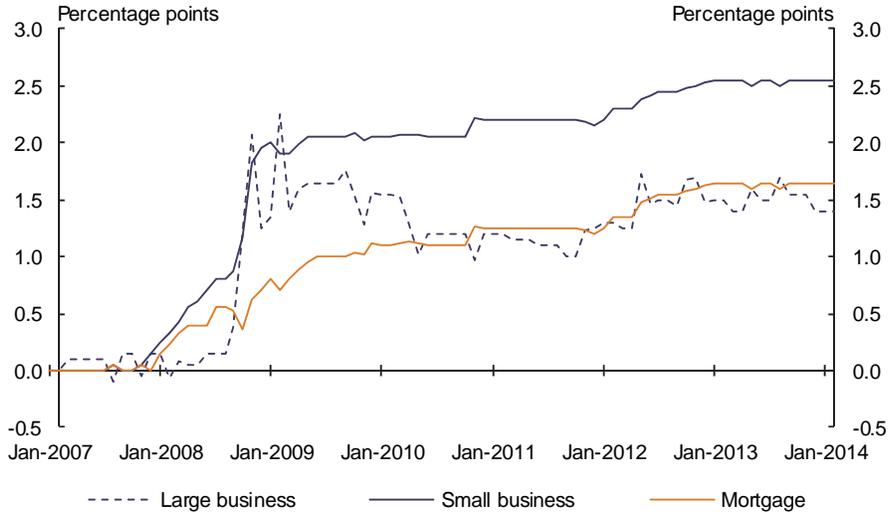
### Access

Access to external debt funding is not a major issue for most SMEs. In general, the majority are successful in getting a loan application approved. Since 2006–07, approval rates have been well above 80 per cent.<sup>36</sup> Approval rates are much lower for new ventures, which reflect the relative riskiness of lending to such enterprises. New ventures usually lack collateral and sufficient proven credit history to qualify for a loan. Such firms can also lack sufficient cash flow until their product can be commercialised.

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<sup>36</sup> Australian Bureau of Statistics (ABS) 2012, *Selected Characteristics of Australian Business 2011–12*, cat. no. 8167.0, ABS, Canberra.

**Chart 3.6: Cumulative change in domestic interest rate spreads**  
(since Jan 2007)



Source: RBA.<sup>37</sup>

In some instances, lenders’ application processes can be overly cumbersome for SMEs.<sup>38</sup> Business owners may not be directed to bank officers who are qualified to provide proper advice on business loan applications, or may be directed to personal loan products because some bank officers lack familiarity with business lending. In some cases, banks do not communicate to business owners why a loan application has been declined.<sup>39</sup>

## Information asymmetries

### *Observation*

There are structural impediments for small- and medium-sized enterprises to access finance. These impediments include information asymmetries, regulation and taxation.

<sup>37</sup> Reserve Bank of Australia (RBA) 2014, *Statistical Tables, Interest Rates, Indicator Lending Rates (F5)*, RBA, Sydney.

<sup>38</sup> NSW Business Chamber, First round submission to the Financial System Inquiry, page 2.

<sup>39</sup> NSW Business Chamber 2013, *Small Business Access to Finance*, NSW Business Chamber, Sydney, page 44.

Information asymmetries are the most significant structural factor contributing to the higher cost and lower availability of credit for SMEs and can be a barrier to competition in SME lending. Limited or no access to information for potential entrants in SME lending increases the cost of establishing SME lending operations.

Lenders typically will have limited knowledge about a new borrower's financial position, the financial performance of the business and the financial behaviour of the business owner. In addition, the SME sector is extremely diverse, so lenders may have limited knowledge of the conditions in, and prospects for, particular industries. Lenders are less likely to lend to newer businesses because the lender lacks familiarity with the customer's financial performance and behaviour.<sup>40</sup> In its submission, the Australian Bankers' Association (ABA) notes:

*Small business loans carry higher risk as small business incomes are more volatile, the arrangements to secure the loans vary significantly, and lenders generally are offered less information to make an assessment of risk partly due to a shorter financial history. As a result, lenders charge small businesses a premium for the higher risk.<sup>41</sup>*

These information asymmetries will be reflected in the price of loans. Banks may have to invest resources to acquire sufficient information to make a well-informed lending decision, which increases the cost of assessing and approving a loan application. When lenders are unable to access sufficient information to make a proper assessment, the risks associated with the loan are generally, and justifiably, perceived to be greater. This leads to higher provisioning and higher loan costs for the borrower.

Some submissions raise concerns about the nature of covenants in loan contracts for SMEs. In particular, submissions suggest that some non-monetary loan covenants are unfair, and the application of some clauses, particularly non-monetary default clauses, could be more transparent. The *Consumer outcomes* chapter explores this issue in further detail and notes that Treasury is currently consulting on the issue. However, some of these covenants are used to deal with the difficulties in bridging the information asymmetries involved in SME lending, and therefore facilitate greater access to lending for businesses.

Many lenders are requiring more security, usually residential property, against business loans.<sup>42, 43</sup> Requirements for collateral to be held against SME loans can result

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40 NSW Business Chamber 2013, *Small Business Access to Finance*, NSW Business Chamber, Sydney, page 36.

41 Australian Bankers' Association 2014, First round submission to the Financial System Inquiry, page 73.

42 Reserve Bank of Australia 2011, *Submission to the Inquiry into Access of Small Business to Finance*. Cited in Export Finance and Insurance Corporation 2014, First round submission to the Financial System Inquiry, page 5.

in allocative inefficiencies, where loans are made to businesses with the best collateral, rather than those that are the best business prospects. The requirement for residential security for a loan disproportionately disadvantages new ventures and younger Australians, who are less likely to have ‘bricks and mortar’ collateral. This issue has become increasingly problematic as housing has become more expensive and many individuals are forced to purchase housing later in life.<sup>44</sup>

## Prudential regulation

Several submissions claim that APRA’s capital requirements have reduced the availability of and/or increased the price of lending to SMEs.<sup>45</sup> Two examples cited are the capital requirements for small business lending and the distinction that is made between corporate and retail business lending.

### Capital requirements

The Inquiry has received little evidence that capital requirements have affected either the supply of lending to SMEs or the relative pricing of secured and unsecured loans beyond what reflects the relative riskiness of the loans. APRA’s submission presents data showing that the average default rate of unsecured small business loans is generally higher than for secured small business loans, which is reflected in the higher risk weights applied to unsecured loans.<sup>46</sup> That said, under the internal ratings-based approach to determine risk weights, discounts are applied to the capital requirements for lending to smaller businesses.<sup>47</sup>

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43 Westpac 2014, First round submission to the Financial System Inquiry, page 63 : “as a responsible lender ... [Westpac] has strict requirements and a limited appetite around the types of unsecured lending made available.”

44 Export Finance and Insurance Corporation 2014, First round submission to the Financial System Inquiry; Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry; Minister for Small Business the Hon. Bruce Bilson 2014, First round submission to the Financial System Inquiry.

45 NSW Business Chamber 2013, *Small Business Access to Finance*, NSW Business Chamber, Sydney; Export Finance and Insurance Corporation 2014, First round submission to the Financial System Inquiry, page 38.

46 Australian Prudential Regulation Authority 2014, First round submission to the Financial System Inquiry, page 79.

47 Australia’s four major banks and Macquarie Bank Ltd use the Basel II internal ratings-based approach to determine risk weights.

Lenders generally make higher provisions for loan losses to reflect the higher expected losses on small business loans. This tends to increase the cost of small business loans, particularly unsecured loans.<sup>48, 49</sup>

### Distinction between corporate and retail business lending

As part of the Basel II 'advanced' approach, a loan can only be treated as 'retail' if it is subject to standardised loan management processes, and if the loan is managed as part of a pool with similar risk characteristics for the purposes of risk assessment and quantification.<sup>50</sup> APRA has deemed that loans less than \$1 million, and subject to such processes, can be treated as 'retail'.<sup>51</sup> This reduces administrative costs for the lender and lowers capital requirements relative to corporate exposures.<sup>52</sup> For borrowers with smaller-sized and less-complex loans, this reduces compliance costs, because these borrowers are generally not subject to the more intensive annual review requirements that apply to borrowers with loans of \$1 million or above.

Increasing the loan-size threshold by which banks distinguish retail from corporate lending might, at the margin, increase SME lending. Some submissions argue that the \$1 million threshold provides a disincentive for firms to borrow more to expand their business activities. Several submissions support raising the threshold. APRA indicates it would be "*willing to consult on raising the \$1 million retail/corporate boundary to \$1.5 million, which would bring it into line (at current exchange rates) with the Basel II framework*".<sup>53</sup>

### Barriers to accessing capital markets directly

SMEs face prohibitively higher fixed costs of raising funds in capital markets, which reduces the capacity of SMEs to use market-based finance.<sup>54</sup> Requirements to prepare a prospectus may discourage some SMEs from seeking equity financing. A prospectus is not required where securities are sold to sophisticated investors, or where a small-scale

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48 Reserve Bank of Australia 2011, *Submission to the Inquiry into Access of Small Business to Finance*. Cited in Export Finance and Insurance Corporation 2014, First round submission to the Financial System Inquiry, page 5.

49 Westpac 2014, First round submission to the Financial System Inquiry, page 63: "as a responsible lender ... [Westpac] has strict requirements and a limited appetite around the types of unsecured lending made available."

50 Australian Prudential Regulation Authority (APRA) 2008, Prudential Standard APS 113, Capital Adequacy: Internal Ratings-based Approach to Credit Risk, page 12.

51 Australian Prudential Regulation Authority (APRA) 2014, First round submission to the Financial System Inquiry.

52 Ibid.

53 Ibid.

54 Matic, M, Gorajek, A and Stewart, C 2012, *Small Business Funding in Australia*, RBA Small Business Finance Roundtable, Sydney, 22 May.

offer is made that raises no more than \$2 million through offers to no more than 20 investors in any rolling 12-month period. This issue is discussed in more detail in the *Equity markets* section in this chapter.

## Venture capital and private equity

Venture capital and private equity funds tend to finance more innovative and high-growth firms. These firms are drivers of long-term productivity growth. Australia's venture capital and private equity markets are small, and there are barriers to generating significant investor interest.

New ventures can typically take several years of development before any cash flows are generated from their activities, and failure rates are high. As a result, new ventures have limited access to credit, and market-based financing can be inaccessible or too costly to acquire.

Over the past two decades or so, the returns from domestic venture capital funds have not provided investors with adequate compensation for the associated risks. Indeed, all Australian venture capital funds formed between 1985 and 2007 had a pooled internal rate of return of minus 1.4 per cent.<sup>55</sup>

The fee structures of venture capital and private equity funds may also discourage some investors. Venture capital fund managers often charge a 2 per cent management fee and take 20 per cent of returns. However, unlike other fund managers, venture capital fund managers are typically very involved in managing the ventures in their funds. Venture capital fund managers provide mentoring services, business expertise, and access to industry and market connections, which is reflected in management and monitoring costs. However, fee structures and the services these fees reflect may not always be transparent to investors. Greater transparency would allow investors to make more informed investment choices and lead to greater competition.

Another barrier to the growth of the venture capital sector is scale. The Australian market may be too small for some ventures to be viable, particularly when it comes to commercialising a product. In addition, certain cultures, particularly relating to risk, and extensive networks need to be developed to facilitate a thriving venture capital industry.

The tax treatment of Venture Capital Limited Partnerships (VCLPs) is complex and may be a barrier to fundraising. Investments made under the VCLP regime are accorded special tax treatment based on whether the investor is domestic or

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55 As of 30 June 2008. Treasury and Department of Industry 2012, *Review of Venture Capital and Entrepreneurial Skills, Final Report*, Treasury, Canberra, referencing the Australian Private Equity and Venture Capital Association, page 39.

international, and whether the treatment of any gains is made on the revenue or capital account. The submission from the Australian Private Equity & Venture Capital Association Limited states that some features of the VCLP tax framework:

*... put Australia's funds management sector at a competitive disadvantage, including ongoing uncertainty in the treatment of some classes of investors. This makes attracting investments into Australia challenging for local fund managers, particularly those that manage funds for offshore clients.<sup>56</sup>*

A recent Board of Taxation Review into the regime's effectiveness made recommendations to simplify and reduce uncertainty, which would reduce barriers to investment.<sup>57</sup>

## Rural business

Although financial issues affect the rural sector, submissions do not identify significant structural issues related to rural finance.

Agricultural incomes are volatile and uncertain. Rural businesses are exposed to large and sometimes prolonged weather events, and weather and pest conditions have a marked effect on the quantity and quality of agricultural products. Prices for agricultural products can be volatile, typically reflecting conditions in international markets, and yields can vary from season to season. However, for those commodities for which Australia is a significant global supplier, domestic supply conditions can materially affect global prices. Rural businesses have access to a range of insurance products to protect against income loss, as well as financial instruments to hedge against commodity price and exchange rate losses.

Debt levels in the agricultural sector have more than doubled over the past decade and have outpaced farm incomes, although the debt-to-income ratio for the rural sector has stabilised since 2011 at around two years of income.<sup>58</sup> Increased indebtedness reflects financial factors, such as lower interest rates and increased availability of credit, and non-financial factors, such as periods of prolonged drought.

Farmers are most likely to experience difficulty meeting debt repayment obligations during periods of low revenue, such as during a drought or a period of low commodity prices. Despite these challenges, the sector has a long history of servicing

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56 Australian Private Equity & Venture Capital Association Limited 2014, First round submission to the Financial System Inquiry, Submission 1, page 19.

57 The Board of Taxation 2011, Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime, June 2011, Canberra.

58 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 132.

debt, albeit with government support. Currently, less than 1.5 per cent of loans to the rural sector are more than 90 days in arrears and bank losses on the portfolio of rural loans are less than 0.5 per cent.<sup>59</sup> Many lenders work closely with farmers in times of financial hardship, often accommodating arrangements such as repayment holidays and using independent mediators to help resolve issues with their customers.

## Policy options for consultation

Policy options to address the structural impediments to funding SMEs range from direct government intervention in the SME lending market to initiatives to reduce information asymmetries.

An important consideration for this Inquiry is whether competition and technological developments will resolve issues related to financing SMEs and early-stage ventures.

Reducing information asymmetries between lenders and borrowers and facilitating more competition in SME lending would improve SME financing. As such, the Inquiry is requesting suggestions and opinions about mechanisms to narrow information asymmetries between lenders and SME borrowers.

One such option, mentioned in some submissions, is to facilitate the development of an SME finance database that could provide business-level data to lenders and potential new market entrants. Data could include details from tax returns and business activity statements, and financial information from lenders.

Ideally, such a database would be managed on a commercial basis, but the Inquiry recognises the barriers to the private sector establishing such a database. Such barriers include restrictions on access to particular information. Entities with the relevant information would need to be able or willing to provide such information. Privacy issues would also need to be considered, and some lenders and borrowers may be reluctant to supply information that could be deemed commercial-in-confidence.

Some submissions suggest the Government could provide facilities that make direct loans to small business, subsidies on loans, or guarantees on loans. Although this would improve the cost and availability of finance to small businesses, taxpayers could bear significant costs and risks, which would be exacerbated by adverse selection as riskier lending prospects are pushed to Government schemes.

Other submissions suggest encouraging superannuation funds to invest in securitised SME loans and venture capital funds. Although this might increase the availability of finance for SMEs, there are currently very few impediments. A mandate requiring superannuation funds to do so may also involve an implicit guarantee by the

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<sup>59</sup> Australian Bankers Association 2014, Submission to Senate Inquiry: Reserve Bank Amendment (Australian Reconstruction and Development Board) Bill 2013, page 6.

Government, which the Inquiry does not consider to be appropriate. Although it is doubtful that a deep market of securitised SME loans could develop, the Inquiry would value views as to how this might be achieved. Superannuation funds could consider investing in venture capital funds as part of a broader approach to diversifying their asset portfolios. This may involve taking a broader view of their investment options and require them to engage the required expertise.

A well-developed broker market for SME lending would likely increase competition among lenders and improve access to finance for SMEs. In recent years, brokers have become more prevalent in some areas of small business lending, particularly equipment finance. However, for other areas of SME lending, the broker market remains relatively undeveloped. This may reflect a combination of transitional issues for the broker industry and structural impediments.

Venture capital funds argue that changing the research and development (R&D) tax credit system to a quarterly basis for new ventures would help alleviate cash flow constraints. New ventures tend to make significant cash outlays in the early stages of the product lifecycle. This is an issue that should be considered as part of the Tax White Paper process.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Facilitate development of an SME finance database to reduce information asymmetries between lenders and borrowers.

*The Inquiry seeks further information on the following areas:*

- To what degree will technological developments resolve issues related to information asymmetries in SME lending?
- What are the best options to narrow the informational gaps between lenders and SME borrowers?
- Could the use of certain loan covenants be reduced, while still providing SMEs with adequate access to finance and lenders with appropriate protection?
- What are the prospects for a market for securitised SME loans developing?
- What are the main barriers to greater broker activity in SME finance? Are these barriers transitional or structural in nature?
- What are the best options for improving the tax treatment of VCLPs?

## External administration

### Recycling capital to new businesses

A well-functioning external administration regime facilitates the efficient recycling of capital and so contributes to the efficiency with which funds are allocated in the economy. It also protects creditors' rights, which promotes confidence in broader credit provision.

There are a number of processes available to businesses under Australia's external administration regime (Table 3.1).

**Table 3.1: Australia's external administration regime<sup>60</sup>**

Process	Description
Voluntary administration	When a voluntary administrator is appointed to control and investigate a company's affairs and make a recommendation to creditors about the company's future and what is in the best interests of creditors.
Liquidation	The orderly wind-up of a company's affairs, distribution of assets to creditors and dissolution under the control of a liquidator.
Controller (including receivership)	Someone who enters into possession or control of the company's property to enforce a security interest.
Schemes of arrangement	An arrangement (approved by the court) between a company and its creditors and/or members to alter their respective rights and interests or to facilitate a reconstruction.
Informal work-outs	Restructuring outside formal external administration.

External administration of an entity involves costs, but it is important that these costs are minimised, so the maximum amount of capital can either be retained in a business that is able to continue operating or reallocated to more productive activities.

Some submissions argue that the current regime is biased towards liquidation.<sup>61</sup> They claim the prohibition on trading while insolvent, and its associated penalties, make directors more cautious in attempting to reorganise a business that could continue to be viable.

Stakeholders suggest that placing a company into voluntary administration can lead to the failure of a business that could survive with some restructuring, because voluntary

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<sup>60</sup> Corporations Act 2001, Chapter 5.

<sup>61</sup> This has also been suggested in Bickerdyke, I, Lattimore R and Madge, A 2000, *Business Failure and Change: An Australian Perspective*, Productivity Commission Staff Research Paper, AusInfo, Canberra, page 89.

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administration processes can significantly devalue a company and involve significant costs.<sup>62</sup>

Others submissions suggest that current arrangements are too complex and costly for SMEs. For example, SME owners are often personally liable when the business is in financial distress, and there are costs associated with navigating the corporate external administration and bankruptcy regimes.

In some cases, liquidator misconduct in areas of improper gain, including excessive remuneration, and liquidator independence and competence affect the cost and effectiveness of liquidation for SMEs.<sup>63</sup>

### Policy options for consultation

To prevent viable businesses from entering voluntary administration, some submissions suggest that Australia adopt the US Chapter 11 regime, or certain aspects of it.<sup>64</sup> The Inquiry considers adopting such a regime would be costly and could leave control in the hands of those who are often the cause of a company's financial distress.<sup>65</sup> Capital would be maintained in a business that is likely to fail, which would restrict or defer the capital from being channelled to more viable and productive enterprises. Adopting such a regime would also create more uncertainty for creditors by limiting their rights. The Inquiry notes that Chapter 11 has rarely enabled businesses to continue as going concerns in the long term.<sup>66</sup>

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62 Parbery, S 2010, 'Assessing Voluntary Administration in Australia: Including Suitability for Workouts, Turnarounds and Pre-Packs', paper presented at the *Supreme Court Annual Corporate Law Conference*, 24 August, Sydney, pages 98–99.

63 ASIC data on liquidator supervision reflects such complaints. Australian Securities and Investments Commission (ASIC) 2014, *Report 389 – ASIC regulation of registered liquidators: January to December 2013*, ASIC, Canberra.

64 Title 11, United States Code, Chapter 11.

65 These are some of the reasons several inquiries have rejected Chapter 11, including the Parliamentary Joint Committee on Corporations and Financial Services 2004, and Corporations and Markets Advisory Committee 2004.

66 The Productivity Commission notes that only around 6.5 per cent of businesses emerge from Chapter 11 as an ongoing entity. See Bickerdyke, I, Lattimore R and Madge, A 2000, *Business Failure and Change: An Australian Perspective*, Productivity Commission Staff Research Paper, AusInfo, Canberra, page 90.

There is little empirical evidence that Australia’s voluntary administration process is causing otherwise viable businesses to fail.<sup>67</sup> The Inquiry would like stakeholders to provide any empirical evidence that supports that view.

The Australian Government released proposals in 2012 to improve liquidator competence, align corporate insolvency and bankruptcy, and promote market competition on price and quality.<sup>68</sup> These proposals seek to mitigate administrative costs for SMEs and curtail the escalation of time-based fee entitlements.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Implement the 2012 proposals to reduce the complexity and cost of external administration for SMEs.

*The Inquiry seeks further information on the following area:*

Is there evidence that Australia’s external administration regime causes otherwise viable businesses to fail and, if so, what could be done to address this?

## Infrastructure financing

Submissions do not raise significant financial system issues that directly relate to infrastructure financing. Where issues are raised, these relate more to issues covered elsewhere in this report, such as the development of the corporate bond market.

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<sup>67</sup> Although ASIC data suggests that most companies that enter voluntary administration fail, data does not suggest that these companies would have remained viable with an informal work-out.

<sup>68</sup> Commonwealth of Australia 2012, Exposure Draft: Insolvency Law Reform Bill 2013, Canberra.

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The major issues submissions raise relate to infrastructure project selection and design, and the implications for the pipeline of greenfield projects. This is consistent with the Productivity Commission's recent draft *Public Infrastructure* report. The Commission found:

*There is no shortage of private sector capital that could potentially be deployed to finance public infrastructure in Australia. Private capital markets will finance most projects at the 'right price'.<sup>69</sup>*

Submissions note a shortage of profitable infrastructure projects to invest in. Industry Super Australia states:

*Industry SuperFunds have already made clear that they would make infrastructure investment of up to \$15 billion over the next five years if appropriate projects were made available. Reform of the bid process could well see them accelerate or even increase that projected level of investment.<sup>70</sup>*

A number of submissions suggest that funding for infrastructure has become more expensive since the GFC. Interest rate spreads on infrastructure projects have increased, including in Australia, Canada, the United Kingdom and the United States.<sup>71</sup> However, this mainly reflects the general re-pricing of risk.

Investments in infrastructure are viewed by some as being illiquid. Infrastructure investment could be facilitated by developing liquid, tradable claims on infrastructure projects. This could provide greater scope for retail and institutional investors, including superannuation funds, to invest in infrastructure.

### *The Inquiry seeks further information on the following area:*

What are the impediments to the development of liquid, tradeable claims on infrastructure projects?

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69 Productivity Commission 2014, *Public infrastructure – Draft Report*, Canberra, page 33. The final report was sent to Government on 27 May 2014, but had not been released at the time this report was published.

70 Industry Super Australia 2014, First round submission to the Financial System Inquiry, page 9.

71 Work by McKinsey Global Institute suggests that interest rate spreads (over LIBOR) for infrastructure projects in advanced economies have increased by less than 100 basis points since the GFC. McKinsey Global Institute 2013, *Infrastructure Productivity: How to Save \$1 trillion a Year*, McKinsey, Dubai, page 21.

## Impact investment and social impact bonds

Impact investment allows investors to align their financial objectives with their personal values by investing in opportunities that offer both social and financial returns. Capital can flow from impact investments made by mainstream financial institutions, institutional investors and philanthropic funds, either directly into social enterprises or via specialist financial intermediaries (Figure 3.2). Capital held by intermediaries then flows into social enterprises through avenues such as direct lending, social investment funds and social investment products managed by these intermediaries.

**Figure 3.2: Sources of funding for social enterprises**



Unlike socially responsible investment, which takes a more passive approach to asset allocations (for example, a managed investment scheme that avoids investments in tobacco businesses), impact investors actively seek social or environmental objectives. As many social benefits cannot be captured by a particular individual, impact investment can increase the level of investment in projects with a high social return.

Impact investment is an important source of capital for organisations that may not be able to access funding from mainstream financial markets. It can encourage new markets, entrepreneurship and innovation to solve entrenched social issues. Recent examples of impact investment include:

- The GoodStart syndicate raised \$165 million for 650 ABC Learning day care centres, which GoodStart now runs on a not-for-profit basis.

- The NSW Government launched a pilot of Australia’s first two social impact bond programs in 2011: \$7 million in capital was raised for UnitingCare Burnside to support families in facilitating their child’s return from foster care, and \$10 million was raised for the Benevolent Society to prevent family breakdowns.

## Barriers to impact investment

More impact investment activity could trigger a marked change in the way governments deal with social or environmental problems by supporting entrepreneurs to find new solutions to entrenched problems. It could also shift governments’ approaches to dealing with these problems from paying for service delivery to paying for outcomes at the best price. However, mobilising the impact investment market may require government support, including removing barriers.

Barriers to investors engaging in impact investment in Australia may include:

- Some superannuation trustees consider their fiduciary duties to be a barrier to impact investment. This is despite there being no explicit prohibition to impact investment provided, superannuation trustees meet the sole purpose test.<sup>72</sup>
- Private and public ancillary funds, which provide a link between donors and organisations that can receive tax deductible donations, are unclear whether they may count discounted returns toward minimum distribution requirements.
- Some private ancillary funds do not meet sophisticated or professional investor tests under the exemptions from the prospectus regime, despite very high net worth individuals or organisations having established them.
- Relatively simple instruments, such as social impact bonds, are subject to onerous disclosure requirements.

## Policy options for consultation

Government could provide guidance to superannuation and philanthropic trustees by explaining how superannuation trustees can facilitate impact investment within the existing regulatory framework. There may also be benefits in exploring options to better use the underlying assets of private and public ancillary funds. To enable private ancillary funds to better reflect their sophistication, it may be possible for such funds to be considered sophisticated or professional investors if the founder of the

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72 Donald, M S, Ormiston, J and Charlton, K 2014, *The Potential for Superannuation Funds to make Investments with a Social Impact*, University of New South Wales, Centre for Law, Markets and Regulation, working paper no. 14-3, May.

fund meets either of these thresholds. Finally, moves to simplify and streamline disclosure requirements could reduce the regulatory burden associated with social impact bonds.

Some submissions propose more active Government involvement in expanding the impact investment market. These include Government providing risk capital to attract initial investments, developing a dedicated social investment bank and introducing tax concessions. The latter should be considered as part of the Tax White Paper process.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Provide guidance to superannuation and philanthropic trustees on impact investment.
- Classify a private ancillary fund as a sophisticated or professional investor for the purposes of the exemptions from the prospectus regime if the sponsor of the fund meets either of these thresholds.
- Simplify and streamline disclosure requirements associated with social impact bonds.
- Undertake a more active role in expanding impact investment, such as providing risk capital and establishing social investment banks.

## Government

In broad terms, governments' main source of funds is tax revenue, and governments use funds to provide services, make transfer payments and fund gross fixed capital formation. For the Australian Government, spending on social security and welfare comprises over one-third of total expenditure.<sup>73</sup> Spending on health, defence and education together accounts for close to another third.<sup>74</sup> Fixed capital investment is another significant component of Government expenditure.

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<sup>73</sup> For the Australian general government sector (excluding state, territory and local governments).

<sup>74</sup> Commonwealth of Australia 2014, *2014–15 Budget, Budget Paper 1, Statement 6*, Estimates for 2014–15 expenditure, Commonwealth Government of Australia, Canberra, page 1.

Governments account for shortfalls in revenue over expenditure by issuing debt. Net issuance of Commonwealth Government Securities (CGS) increased sharply after 2007–08 as the budget moved into deficit with the onset of the GFC.<sup>75</sup> The stock of CGS on issue is expected to increase to \$360 billion by the end of 2014–15, which would be equivalent to 0.2 years of GDP.<sup>76</sup>

## Role of government in the financial system

The CGS market plays a very important role in Australia’s financial system. The CGS market is highly liquid. It provides a risk-free interest rate curve that other debt instruments can be priced from. The Australian Office of Financial Management recently extended the length of the CGS yield curves to 20 years, which provides a benchmark for longer-dated debt securities.

Around 70 per cent of CGS on issue is held by non-residents.<sup>77</sup> Investor confidence in the Australian sovereign debt market reflects the relative strength of Australia’s public finances and the Australian economy more broadly.

CGS (and state government debt securities) represent a major source of high-quality liquid assets (HQLAs) for the financial system. HQLAs are unencumbered assets that can be readily converted to cash with little or no loss in value, even in stressed market conditions. To manage liquidity requirements, financial institutions (particularly banks) require holdings of assets that can be converted to cash, sometimes at short notice. Financial entities active in derivatives markets also require HQLAs to use as collateral in derivatives transactions.<sup>78</sup>

## The banking system

The banking sector plays a central role in the Australian financial system. Banks transform short-term liabilities into long-term assets, but they must manage the liquidity, credit and other risks associated with this activity. This intermediation process is an important mechanism by which funds are channelled from savers to

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75 Commonwealth of Australia 2014, *2014–15 Budget, Budget Paper 1, Statement 10*, Commonwealth Government of Australia, Canberra, page 6.

76 Commonwealth of Australia 2014, *2014–15 Budget, Budget Paper 1, Statement 7*, Commonwealth Government of Australia, Canberra, page 5.

77 As at the December quarter 2013, 67.5 per cent of total CGS on issue was held by non-residents of Australia. Commonwealth of Australia 2014, *2014–15 Budget, Budget Paper 1, Statement 7*, Commonwealth Government of Australia, Canberra, pages 7–10.

78 Reserve Bank of Australia 2012, *Financial Regulation and Australian Dollar Liquid Assets*, RBA *Bulletin*, September Quarter, RBA, Sydney.

borrowers to facilitate business investment and household purchases of major assets, and to help businesses and households manage their liquidity requirements.

## The effect of Basel III on bank funding

### Capital

Some submissions argue that APRA's approach to implementing Basel III capital has materially increased bank funding costs; however, these submissions do not quantify the effect new capital requirements have had on loan pricing. Submissions note that Basel III not only requires banks to use more capital funding, but that capital must be of a higher quality, which tends to be more expensive. Some submissions argue that APRA has taken a more conservative approach than in some other jurisdictions. While true, it can also be argued that APRA's approach has, to some degree, reduced the risk premia paid by Australian banks on wholesale debt, which acts to reduce wholesale funding costs. Furthermore, as discussed in the *Stability* chapter, Australian banks' actual capital ratios lie roughly in the middle of the pack when compared to other jurisdictions on a consistent basis.

On balance, it is difficult to ascertain whether APRA's approach to implementing Basel III capital will materially affect Australian banks in terms of pricing or access to funding (domestically or internationally) or whether it has had a significant effect on loan pricing in Australia.

### Liquidity

Under the liquidity coverage ratio (LCR), to be implemented in Australia from 2015, some banks will be required to hold unencumbered HQLAs to cover net cash outflows in a 30-day stress event.<sup>79</sup> The proposed net stable funding ratio (NSFR) sets the required amount of longer-term funding against longer-term assets. The Inquiry notes that APRA has implemented a regime that is broadly in line with the Basel III liquidity framework.

An important aspect of the implementation of the Basel III liquidity reforms in Australia was the establishment of the Committed Liquidity Facility (CLF) at the Reserve Bank of Australia. Use of a CLF is allowed under the Basel rules for jurisdictions like Australia with insufficient HQLAs. This means those authorised deposit-taking institutions (ADIs) subject to the LCR are able to include the CLF amount towards meeting their LCR requirement. The CLF will also get some recognition in the proposed NSFR regime; third-party assets eligible for inclusion in

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<sup>79</sup> Those authorised deposit-taking institutions (ADIs) with simple, retail-based business models are subject to a simple liquidity ratio requirement under the minimum liquidity holdings regime.

the CLF will receive a treatment in the NSFR that reflects their enhanced liquidity characteristics.

Overall, the new capital and liquidity arrangements do impose extra constraints on banks' balance sheets, although it is less clear that these constraints are having a significant effect on lending activities. The capital requirements means banks must use more capital funding than they otherwise might choose and the liquidity requirements place extra constraints on banks' sources of funding and uses of that funding. This could limit banks' ability to finance new projects and slow the rate of gross fixed capital formation. However, APRA's approach may put downward pressure on the cost of funds for banks. Using more capital funding and holding more liquidity is more likely to enhance the stability of the financial system and give more confidence to wholesale investors and depositors, which is reflected in lower risk premia required by these providers of funds.

## Funding credit growth

Several submissions, mainly from the banking sector, question how the banking system would fund higher economic growth in Australia.<sup>80</sup> These submissions argue that ADIs would be unable to fund higher credit growth with new deposits. The 'funding gap' between credit and deposits is largely funded using wholesale debt. Some of this debt is issued overseas in foreign currency, which involves some risks if there are disruptions in these markets, such as the turmoil during the GFC. To ameliorate these risks, submissions argue that higher deposit growth should be encouraged, that further development of a corporate bond market is required, and that the superannuation system should be encouraged to allocate more funds to deposits and fixed income products.

Stewart, Robertson and Heath (2013) argue there is no reason to believe that higher demand for credit or reduced supply of deposits would disrupt economic growth.<sup>81</sup> Lenders can change the interest rates they charge on loans, while the cost of different funding liabilities will be determined by investor preferences and the willingness of banks to supply different funding instruments.<sup>82</sup> In its submission, ANZ states that

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80 For example, PricewaterhouseCoopers 2014, First round submission to the Financial System Inquiry, page 64; Westpac 2014, First round submission to the Financial System Inquiry, page 45.

81 Stewart C, Robertson B and Heath A 2013, *Trends in the Funding and Lending Behaviour of Australian Banks*, Research Discussion Paper 2013-15, Sydney.

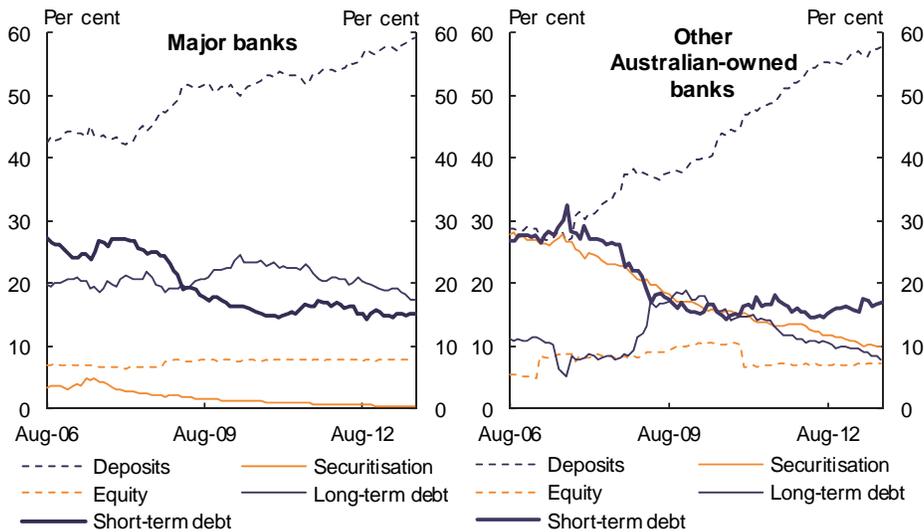
82 Stewart C, Robertson B and Heath A 2013, *Trends in the Funding and Lending Behaviour of Australian Banks*, Research Discussion Paper 2013-15, Sydney.

markets for bank funding are generally efficient and do not impede the banking system’s ability to fund economic growth.<sup>83</sup>

In the view of the Inquiry, high-quality projects and viable enterprises would still be able to obtain funding through other channels if insufficient credit was available. But it acknowledges entities that are more reliant on loans, such as small businesses, would have some difficulty accessing funding.

Despite these arguments, the Inquiry acknowledges that the composition and stability of the funding for ADIs are important. A more stable funding composition enhances the ability of ADIs to fund long-term loans. The Inquiry recognises the need for some adjustments, particularly to tax, to ensure a more efficient allocation of funding in the economy.

**Chart 3.7: Sources of bank funding**



Note: Deposits in this chart are domestic deposits. Deposits of non-residents are included in Short-term debt. Source: ABS.<sup>84</sup>

In the period leading up to the GFC, banks had been using a greater proportion of wholesale debt funding (particularly from offshore) than they do today. In part, this was because of the ease by which short-term debt could be rolled over. When funding markets were dislocated during the GFC, Australian ADIs found it difficult to roll over short-term debt and to obtain wholesale funding. It also became difficult to sell securitised loans; securitisation markets had become an important source of funds for

83 ANZ Bank 2014, First round submission to the Financial System Inquiry, page 1.

84 Australian Bureau of Statistics 2014, *Australian National Accounts: Financial Accounts*, December 2013, cat. no. 52320, ABS, Canberra.

smaller ADIs and non-bank lenders. These events made it more difficult for ADIs to meet the demand for credit and led ADIs to their funding risks.

Market pressures, including from ratings agencies, resulted in a shift of funding towards more stable sources, particularly retail deposits. Deposits now represent a larger share of bank funding than they did before the crisis, and banks increased the maturity structure of their wholesale debt to manage their liquidity risk better (Chart 3.7). The shift in the funding mix was driven by a re-pricing of bank liabilities, and some entities, such as superannuation funds, switched away from bank wholesale debt to wholesale deposits.<sup>85</sup> However, more intense competition for deposits and the higher cost of alternative sources of funding led to an increase in the cost of deposits for ADIs.

## Deposits

Some of the difficulty in attracting deposits from households relates to the tax treatment of products that pay returns in the form of interest. Compared to other savings vehicles, such as housing and equities, returns from deposits are taxed unfavourably. In its submission, Westpac states:

*Westpac recommends the Inquiry considers measures for tax equalisation between bank deposits and other competing savings options. The specific nature of these measures should be considered in the Government's tax white paper process.<sup>86</sup>*

At the margin, this results in ADIs having to offer higher interest rates to attract deposits, which raises the cost of funds and lending rates in the economy.

The relative unattractiveness of deposits to households has helped drive the trends in the composition of bank deposits (Chart 3.8). Deposits held directly by households have accounted for a declining share of total bank deposits. In contrast, the share of deposits from superannuation funds has been rising. Demand for deposits by superannuation funds has been driven by strong growth in member contributions and higher demand for liquid assets.

As mentioned earlier in this section, some submissions suggest that superannuation funds should allocate more of their assets to deposits and long-term wholesale debt. Some stakeholders argue that a lower share of deposits directly held by households and a higher share of deposits from larger superannuation funds may, in fact, make it more difficult for ADIs to write long-term loans. Given that deposits made by large APRA-regulated superannuation funds are less sticky than retail deposits, ADIs would be required to hold a larger quantum of liquidity if they were managing their liquidity

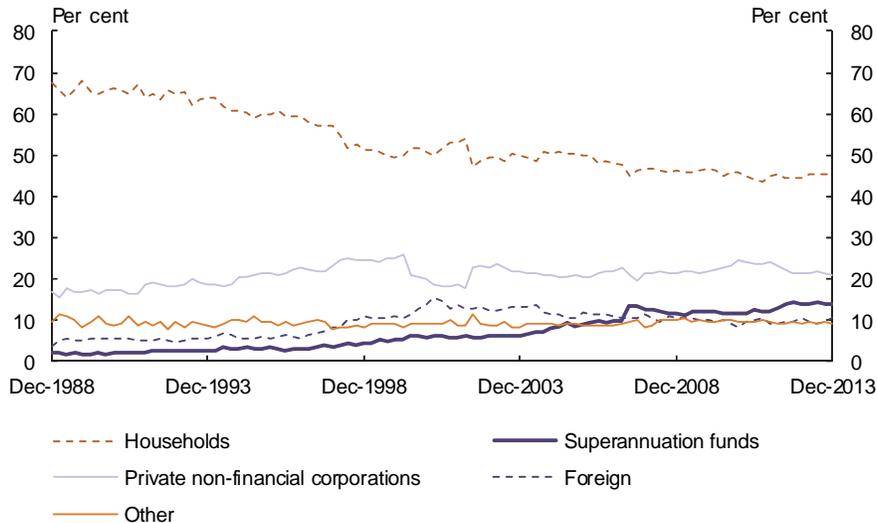
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<sup>85</sup> Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 183.

<sup>86</sup> Westpac 2014, First round submission to the Financial System Inquiry, page 48.

risks prudently. Under the LCR regime, the marginal liquidity required against an extra dollar of a superannuation deposit would come from self-securitised assets that already exist on the balance sheet of the LCR ADIs. Given the superannuation sector will become an increasingly large source of deposits for the banking system, it is unclear to the Inquiry what effect this will have on the banking system and the flow of funds in the economy more broadly.

**Chart 3.8: Sources of bank deposits<sup>87</sup>**



Source: ABS.<sup>88</sup>

*The Inquiry seeks further information on the following areas:*

- What effect is the implementation of the Basel III capital and liquidity regimes in Australia expected to have on the cost of funds, loan pricing and the ability of banks to finance new (long-term) loans? How large are these effects expected to be?
- What share of funding for ADIs is expected to come from larger superannuation funds over the next two decades? What effect might this have on bank funding composition and costs? What effect will this have on the ability of ADIs to write long-term loans?

<sup>87</sup> Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 183.

<sup>88</sup> Australian Bureau of Statistics (ABS) 2014, *Australian National Accounts: Financial Accounts*, December 2013, cat. no. 5232.0, ABS, Canberra.

## Superannuation

The superannuation sector is a significant and growing source of funding for the rest of the economy. The asset allocation decisions made by the superannuation sector will have significant implications for the flow of funds in the economy.

### The size and composition of superannuation assets

As of 31 March 2014, the superannuation sector held \$1.8 trillion in assets.<sup>89</sup> By comparison, the Australian Securities Exchange (ASX) market capitalisation is roughly \$1.6 trillion.<sup>90</sup> Financial assets held in the superannuation system were 50 per cent of those of the banking system in 1997 but had grown to 60 per cent by the end of 2013.<sup>91</sup>

Structural developments in the superannuation system have affected how assets in superannuation funds are allocated. These developments reflect changes to industry composition, particularly the growth of Self-managed Superannuation Funds and Australia's ageing population.

APRA-regulated funds have a vastly different asset allocation to that of SMSFs. They are more heavily invested in foreign equities and fixed income, while SMSFs have a higher allocation towards domestic equities, property, and cash and deposits (Chart 3.9). The differences in the asset allocations reflect certain features of SMSFs:

- SMSFs have an older membership than APRA-regulated funds, so they are more likely to have a more defensive asset allocation.
- APRA-regulated funds have better access to foreign equity and wholesale fixed income markets, although product developments, such as exchange-traded funds and retail bonds, will make it easier for SMSFs to access such asset classes in the future.
- SMSFs typically cannot take advantage of the pooling benefits available to larger funds.

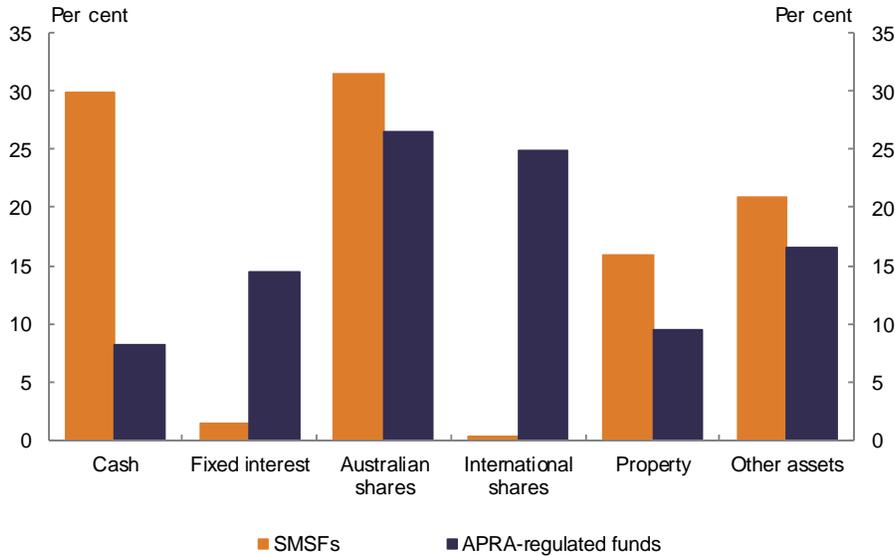
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89 Australian Prudential Regulation Authority (APRA) 2014, *Quarterly Superannuation Performance (interim edition)*, APRA, Sydney, Page 6.

90 As at the end of April 2014. Australian Securities Exchange (ASX) 2014, *Historical market statistics*, ASX, Sydney.

91 Australian Bureau of Statistics (ABS) 2014, *Australian National Accounts: Financial Accounts*, December 2013, cat. no. 5232.0, ABS, Canberra.

**Chart 3.9: Asset allocation of superannuation funds, 2013**



Sources: APRA and ATO.<sup>92</sup>

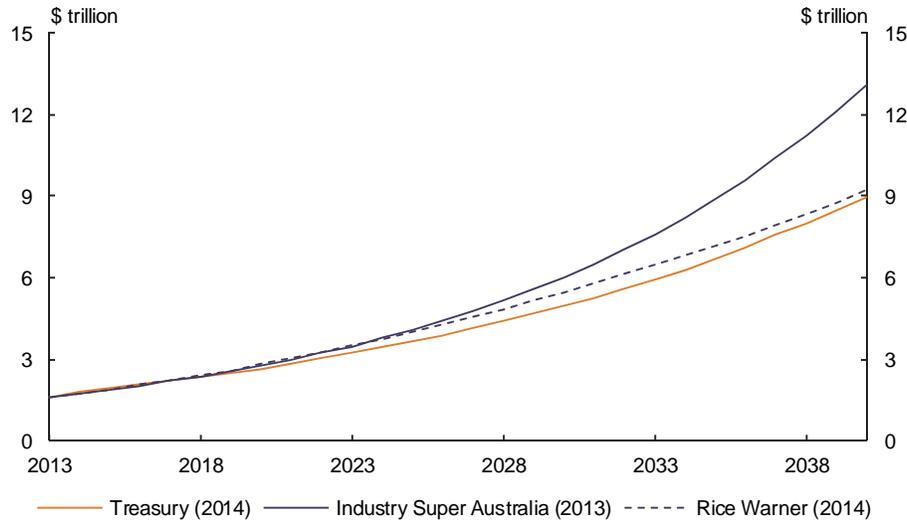
### Future trends

Australia’s superannuation assets are expected to continue to grow at high rates for the foreseeable future and exceed the growth of the economy. This growth will be driven by the increase in the Superannuation Guarantee (SG) rate to 12 per cent by 2022, investment returns, and tax concessions on superannuation contributions and earnings. There are a range of projections of future superannuation asset growth (Chart 3.10). Industry Super Australia projects superannuation assets will exceed those of the banking sector by the early 2030s.<sup>93</sup> This reinforces the importance of the superannuation sector in funding economic activity.

92 Australian Taxation Office (ATO) 2013, *Self-Managed Super Fund Statistical Report – December 2013*, ATO, Canberra. APRA 2013, *Annual Superannuation Bulletin*, June 2013 (revised 5 February 2014). Asset allocation is for the default investment strategy.

93 Industry Super Australia 2014, First round submission to the Financial System Inquiry, page 117.

**Chart 3.10: Total superannuation assets: projections**



Sources: Industry Super Australia, RiceWarner and Treasury.<sup>94</sup>

Superannuation assets relative to GDP will eventually peak towards the end of the 2030s, according to one submission, as the number of retirees continues to increase relative to the workforce.<sup>95</sup>

As the assets in the superannuation system grow relative to the supply of domestic financial assets, superannuation funds may look towards other asset classes and increase their relative allocation of offshore assets. A report prepared by RiceWarner and commissioned by the Actuaries Institute for the Inquiry, argues it is possible that funds will allocate a higher proportion of their assets to overseas investments because of the reduced capacity for the Australian market to absorb those funds. This would have implications for Australia’s balance of payments.

<sup>94</sup> Treasury 2014, Industry Super Australia 2013, RiceWarner 2014, *Ageing and Capital Flows*, commissioned by the Actuaries Institute. The projections by Rice Warner include the effects of inflation.

<sup>95</sup> RiceWarner 2014, *Ageing and Capital Flows*, commissioned by the Actuaries Institute, Sydney.

The other major development in the superannuation system is the trend towards a greater share of assets in the retirement phase. Currently, around 30 per cent of assets are held in the retirement phase, but this is expected to increase to more than 40 per cent over the next 30 years.<sup>96</sup> RiceWarner argues, among other points:

- The conservatism of retirees as they age is likely to result in a greater proportion of total assets invested defensively, such as in Government and corporate bonds. Older superannuants are also likely to prefer yield over capital appreciation.
- Defensive overlays will increasingly be used to protect members against significant falls in asset values. This will require greater depth in derivative markets and include balance sheet guarantees of banks and insurers, which will require them to expand their capital bases.
- As argued in the *Retirement income* chapter, there will be increasing interest in products that protect against longevity risk. The increase in demand for products like lifetime annuities will increase the demand for and use of fixed income assets.

The same report also argues that consolidation in the superannuation market will be accompanied by a shift to more illiquid assets as the cash flows for large funds become larger and more predictable. This is discussed further in the *Superannuation* chapter.

The demand for fixed income products could also stimulate demand for securitised assets, which is an important funding source for smaller lenders. Further, superannuation funds could engage in direct lending to households and businesses in direct competition with the banking sector, which has already occurred in other economies, such as the United Kingdom. This would require superannuation funds to develop credit assessment capabilities and would have implications for how funds might be regulated.

*The Inquiry seeks further information on the following area:*

What effects will the trends in the size and composition of superannuation have on the broader flow of funds in the economy over the next few decades, including on international capital flows to and from Australia?

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<sup>96</sup> RiceWarner 2014, *Ageing and Capital Flows*, commissioned by the Actuaries Institute, Sydney.

## The corporate bond market

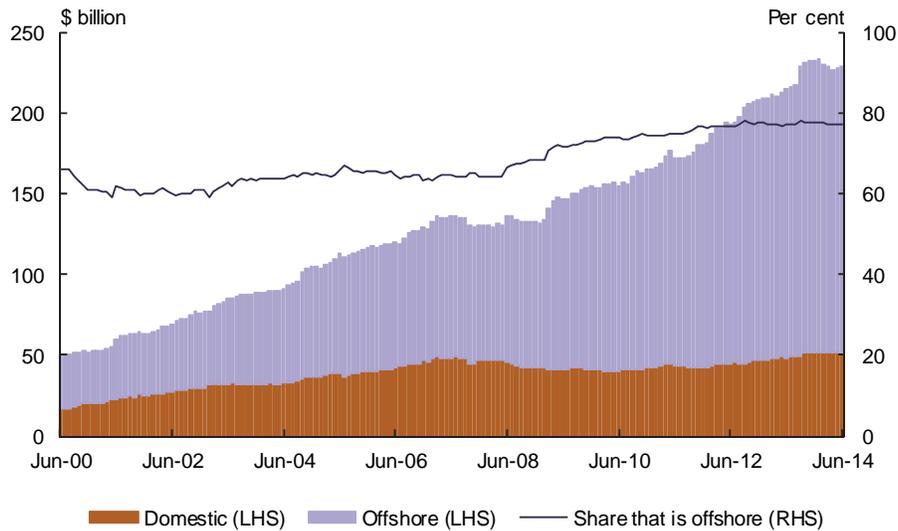
A deeper and more liquid corporate bond market would provide diversification benefits to both issuers and investors.

Over recent years, bond issuance by Australian corporates has increased steadily, with 80 per cent of issuance in offshore markets (Chart 3.11). On average, around 30 bonds are issued in the domestic market per year, with a slightly higher number of offshore issues, which are generally larger.<sup>97</sup> Traditionally, private non-financial corporations have made relatively little use of the domestic market. In recent years, domestic issuance has been dominated by the major banks.<sup>98</sup>

### Observation

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

**Chart 3.11: Australian corporate bonds outstanding**  
(by market of issuance, market value)



Source: RBA.

97 Lowe, P (Deputy Governor, Reserve Bank of Australia) 2014, *Opportunities and Challenges for Market-based Financing*, speech to the ASIC Annual Forum 2014, 25 March, Sydney.

98 From mid-2007 to the end of 2011, the major banks accounted for around 60 per cent of issuance since mid-2007. Black S, Kirkwood J, Rai A and Williams T 2012, *A History of Australian Corporate Bonds*, Reserve Bank of Australia, Research Discussion Paper 2012-09, Sydney.

In the international context, Australia's pattern of corporate debt financing is fairly typical. The proportion of debt funding for Australian corporates that is intermediated by banks is broadly consistent with that of other advanced economies with the exception of the United States, which has an unusually large corporate bond market.<sup>99</sup> Corporates in Australia and other advanced economies tend to issue bonds in Europe and the United States.

In Australia, it is more common for corporate bonds to be issued into the wholesale market and traded over the counter. Despite this, a small number of public offers of listed corporate bonds are made to investors each year. Unlike in the United States, there is limited public transparency in the over-the-counter corporate bond market in Australia.<sup>100</sup> Since the corporate bond market in Australia is largely over-the-counter and lacks transparency, retail investors are effectively precluded from investing directly in these bonds.

For lower-rated or unrated corporates, raising funds through bond issuance can be challenging, particularly for tenors longer than seven years. That said, market conditions for both lower-rated and longer-dated issuers have improved recently, with more Australian dollar BBB-rated issuance and at longer tenors in 2013 than in previous years.<sup>101, 102</sup>

In recent years, the Government has taken a number of steps to stimulate the corporate bond market:

- The Australian Office of Financial Management has extended the length of the yield curves for CGS to 20 years.
- The RBA has begun publishing pricing data for non-financial corporate bonds.<sup>103</sup>

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99 Reasons for the exceptionally large US corporate bond market include the fragmented banking system, a long history of credit ratings agencies, the size of the funds management industry, an investor base familiar with fixed income assets, the most liquid government debt market and the status of the US dollar as the world's reserve currency.

100 In the US, the Trade Reporting and Compliance Engine (TRACE) is a vehicle that facilitates mandatory reporting of over-the-counter secondary market transactions in certain kinds of US corporate bonds. TRACE was developed by the Financial Industry Regulatory Authority, a self-regulatory organisation of financial market participants. TRACE became operational on 1 July 2002.

101 Debelle, G (Assistant Governor, Financial Markets, Reserve Bank of Australia) 2014, *The Australian Bond Market*, speech to the Economic Society of Australia, 15 April, Canberra.

102 Lowe, P (Deputy Governor, Reserve Bank of Australia) 2014, *Opportunities and Challenges for Market-based Financing*, speech to the ASIC Annual Forum 2014, 25 March, Sydney.

103 See Reserve Bank of Australia (RBA) 2014, *Statistical Tables, Aggregate Measures of Australian Corporate Bond Spreads and Yields (F3)*, RBA, Sydney.

- The Government has made exchange-traded Commonwealth Government Bonds available for trading on the ASX since May 2013, to provide a visible pricing benchmark for corporate bonds and to encourage retail investors to consider diversifying their asset portfolio to fixed income products.<sup>104</sup>

In addition, legislation currently before Parliament aims to simplify the prospectus requirements for retail ‘vanilla’ bonds and reduce the liability of company directors issuing these simple bonds to retail investors.<sup>105</sup>

## Alternative funding sources for corporates

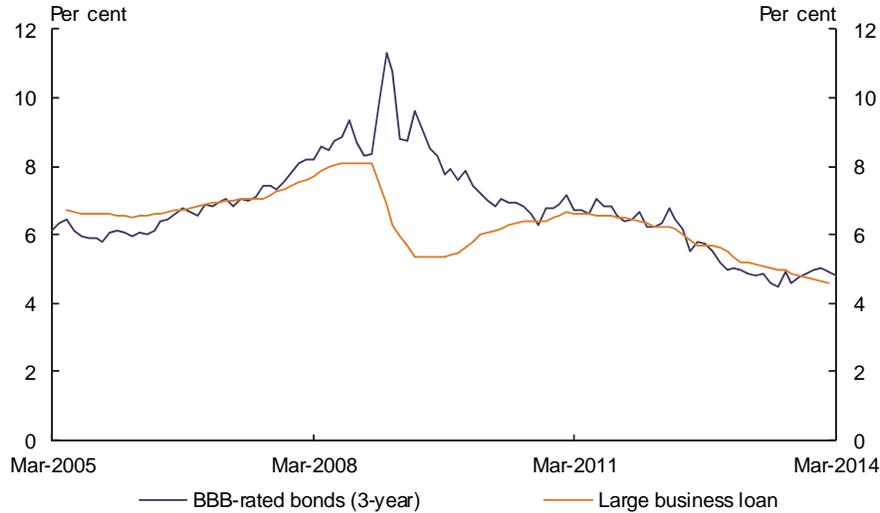
Australian corporates generally have good access to alternative funding sources. Bank and syndicated loans are usually offered at interest rates similar to those available in the bond market (Chart 3.12). Loans can involve lower fixed costs, and funds can be accessed in a more flexible way. However, the tenor of funding available from banks may not be as long as bonds, and covenants in loan contracts can make bond funding more attractive. In some jurisdictions, syndicated loan participations are tradable and therefore available to other investors. This is rare in Australia.

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104 Revised Explanatory Memorandum, *Commonwealth Government Securities Legislation Amendment (Retail Trading) Bill 2012*.

105 The *Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014* was introduced into the winter sitting of Parliament, but is yet to be passed. ‘Vanilla bonds’ are defined in the Bill as having certain features including a face value of less than \$1,000, a maturity of less than 15 years, and being issued by a listed entity or wholly owned subsidiary of one.

Chart 3.12: Interest rates on corporate debt



Source: RBA.<sup>106</sup>

Offshore debt markets are often more attractive to Australian corporate issuers. These markets, particularly in the United States, often provide funding for Australian corporates at a lower cost, for longer tenors, in larger sizes and to lower-rated issuers than the domestic market. In some countries, the double taxation of dividends has tended to encourage debt funding over equity, which has directly contributed to the size of bond markets offshore.

## Domestic demand for corporate bonds

Australian investors' appetite for fixed income securities is arguably lower than in some other advanced economies.<sup>107</sup> The tax system treats fixed income securities unfavourably compared to other savings vehicles (see Chart 3.2 in the *Household saving* section in this chapter). In addition, the dominance of defined contribution superannuation and the relatively low proportion of superannuation assets currently in the retirement phase explain why superannuation funds are more heavily invested in equities than in corporate bonds. The domestic corporate bond market is relatively illiquid compared to markets for other assets, and the lack of issuers limits investors' ability to diversify credit risk in their portfolios.

<sup>106</sup> Reserve Bank of Australia (RBA) 2014, *Statistical Tables, Aggregate Measures of Australian Corporate Bond Spreads and Yields (F3) and Interest Rates, Indicator Lending Rates (F5)*, RBA, Sydney.

<sup>107</sup> Particularly for pension funds. Organisation for Economic Cooperation and Development (OECD) 2013, *Pension Markets in Focus*, OECD, France.

Some potential wholesale investors in corporate bonds are only able to invest in rated securities under their investment mandates. Investors use credit ratings as a proxy for, or to provide comfort in the absence of, their own independent credit assessment. However, some issuers find the cost of obtaining a credit rating from major rating agencies to be prohibitive. A factor affecting public offerings is that some ratings agencies will not consent to ratings being used within a prospectus, due to liability concerns and a requirement to participate in mandatory dispute resolution mechanisms.<sup>108</sup>

Issuers also face impediments in making public offers of listed corporate bonds, particularly to retail investors. Submissions raise issues with the application of the prospectus requirements for public offerings and the scope of exemptions from the prospectus regime for offerings to sophisticated individuals. Submissions also raise issues of cost and the liability regime associated with prospectuses. In particular, listed companies query why they cannot rely on a prospectus exemption similar to that for issuing further equity, which is based on compliance with the continuous disclosure regime, when they issue listed debt. To some degree, the reforms currently before Parliament deal with these issues.<sup>109</sup>

### Policy options for consultation

Some trends could contribute to the natural deepening of the ‘vanilla’ corporate bond market. In particular, as the superannuation system matures and the population ages, demand for fixed income products is likely to increase.

Some submissions suggest policy options to improve access for retail investors to the corporate bond market. Potential policy options include:

- Allowing listed issuers (already subject to continuous disclosure requirements for at least 12 months in respect of their listed equity) to issue listed ‘vanilla’ bonds directly to retail investors without the need for a prospectus<sup>110</sup>
- Reviewing the size and scale of corporate ‘vanilla’ bond offerings that can be made without a prospectus where the offering is limited to 20 people in 12 months up to a value of \$2 million<sup>111</sup>

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108 A ratings agency that provides ratings to retail investors through a prospectus is required to obtain an Australian Financial Services Licence as the rating amounts to general financial advice. As a licensee, the ratings agency would need to be a member of an external dispute resolution scheme.

109 *The Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014*.

110 Consistent with Corporations Act, s708AA right issue relief.

- Reviewing the size and scale of corporate ‘vanilla’ bond offerings that can be made without a prospectus where the offering is less than \$10 million and an offer information statement is offered to investors<sup>112</sup>

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*The Inquiry seeks further information on the following areas:*

- As a greater share of the population enters retirement, would the demand for fixed income products increase in the absence of regulation or other incentives?
- Would the development of annuity-style retirement income investment products encourage the growth of fixed income markets?
- Could enhanced transparency of transactions improve liquidity in the over-the-counter Australian corporate bond market, including its attractiveness to retail investors? What commercial or regulatory impediments are there to the potential development of improved transparency in the over-the-counter corporate bond market?
- Could alternative credit ratings schemes develop in Australia and would this help improve the appetite for bonds, particularly those of growing medium-sized enterprises? Could alternative standards of creditworthiness develop in Australia? What are the barriers to such developments, and what policy adjustments would assist such developments?

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111 Corporations Act, s708: “where the offer is a personal offer, and offers or invitations have been made to fewer than 20 persons in the previous 12 months, and the new offer will not result in more than \$2 million being raised in that 12 months”. The value (\$2 million) has remained unchanged since its introduction in 2001.

112 Corporations Act, s709(4). The change from \$5 million to \$10 million was in 2007.

## Equity market

Equity financing is the main source of funding for Australian corporations. During the GFC, secondary capital raisings by listed entities played a particularly important role in securing funding during a period when financial conditions deteriorated and there was greater uncertainty in wholesale debt and credit markets.

### Access to equity capital markets

Almost 90 per cent of ASX-listed companies, or around 2,000, have a market capitalisation below \$300 million. These companies are generally described as ‘mid-caps’. They include a large number of smaller mining and prospecting companies and start-up companies.

For mid-caps, the cost of issuing equity can be prohibitive. Compared to large corporates, mid-caps face disproportionately larger fixed costs of issuance. In addition, because mid-caps are generally not well known, they may have additional promotional costs. They are also less able to absorb costs associated with listing, such as complying with listing rules and corporate governance requirements.

There may be scope for Australia’s listed markets to become more inclusive. This year, the London Stock Exchange has developed a market segment for high-growth companies, such as internet and technology companies that are expected to, in time, seek a listing on the main board.<sup>113</sup> Options might be available to take a similar course in Australia to provide smaller entities easier access to equity market listing, although the ASX discontinued a second board market in 1992.

Australian law provides some concessions on preparing prospectuses for low-value capital raisings. Submissions suggest these thresholds could be relaxed; for example, through higher limits for the amount of funding that can be raised under the ‘20 in 12’ prospectus exemption, or for a larger number of investors that can result in investing under that same exemption.<sup>114</sup>

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113 This new high-growth segment was developed jointly by the UK Government and London Stock Exchange. It is in addition to the second board called AIM, *High Growth Segment*, <<http://www.londonstockexchange.com/companies-and-advisors/main-market/companies/hgs/hgs.htm>>.

114 Australian Shareholders Association 2014, First round submission to the Financial System Inquiry, page 7. The ‘20 in 12’ prospectus exemption is in s708(1) Corporations Act.

## Access for retail investors to new equity offers

Some submissions raise concerns about equity issuance by companies during the GFC that excluded retail investors. In its submission, the Australian Shareholders' Association (ASA) states:

*Retail investors were diluted out of more than \$10 billion worth of value during the raft of capital raisings which occurred in the immediate aftermath of the global financial crisis. The primary causes were discounted institutional placements with no follow-up SPP (share purchase plan), unfairly restricted SPPs, a lack of renounceability in entitlement offers, separate book builds to deal with institutional and retail shortfalls and poorly marketed retail offers and limits on the ability of shareholders to apply for additional shares in entitlement offers.<sup>115</sup>*

In particular, submissions argue that institutional placements and non-renounceable entitlement offers dilute retail investors. These submissions argue that rules relating to these secondary equity issues should be modified so that such 'dilution' cannot occur.<sup>116</sup>

Arguably, the fact that companies were able to use these methods enabled them to access funding more quickly and with greater certainty than otherwise would have been the case. An ASX report discussing the markets' performance during the GFC noted that, as market conditions stabilised, the weighting companies applied to considerations of 'fairness' for all shareholders increased and the relative attractiveness of pro-rata issues rose, particularly for accelerated rights offers.<sup>117</sup>

Submissions put forward a number of suggestions to address dilution concerns. The Inquiry notes that recent developments in market technology could make it easier for companies to offer placements to the market and rights issues to all shareholders. Suggestions to address dilution include modifying private placement requirements by:

- Requiring that all existing investors be invited to participate in any on-market equity issue of continuously disclosing securities
- Requiring by law that all issues of new equity by issuers be conducted fairly, transparently and efficiently, unless shareholders approve the issue, despite not satisfying these criteria

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115 Australian Shareholders Association 2014, First round submission to the Financial System Inquiry, page 21.

116 Under listing rule 7.1, every listed entity has the ability to issue 15 per cent of its issued capital via a placement without security-holder approval in a 12-month period. Some entities with security holder approval have the ability to issue an additional 10 per cent of issued capital in a 12-month period under listing rule 7.1A

117 Australian Securities Exchange 2010, *Capital Raising in Australia: Experiences and Lessons from the Global Financial Crisis*, ASX Information Paper, ASX, Sydney.

## Access to crowd-sourced equity funding

The Corporations and Markets Advisory Committee (CAMAC) recently released a Report with recommendations to help unlisted entities seek crowd-sourced equity funding (CSEF).<sup>118</sup> The Report finds that the lack of a supportive regulatory environment for CSEF may result in worthwhile Australian entrepreneurs incorporating in other countries, or moving their businesses offshore to enable their ideas or projects to be more easily funded. The report is currently being reviewed by the Government.

In the view of CAMAC, for this form of corporate fundraising to operate in the best interests of investors, as well as issuers, a regulatory structure specifically designed for CSEF needs to be developed. This would include introducing a new corporate status – an ‘exempt public company’ – that would allow companies to seek crowd-sourced equity funding and a disclosure regime based on a standard offer disclosure template.

## Policy options for consultation

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*The Inquiry seeks further information on the following areas:*

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

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<sup>118</sup> Australian Government, Corporations and Markets Advisory Committee 2014, *Crowd Sourced Equity Funding*, Australian Government, Canberra, May.

## 4: Superannuation

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Superannuation is primarily a long-term savings vehicle to fund retirement. Australia's superannuation sector has grown rapidly in the period since the Wallis Inquiry and is an important source of funding for long-term capital formation, which is important for productivity growth. Although the superannuation system has considerable strengths, the efficiency of the system is a significant issue.

The Inquiry has examined the superannuation issues most relevant to the financial system and the economy. In general, it is difficult to separate these issues from Government policy settings because the size and growth of the superannuation system are largely a creation of Government policy. The Inquiry acknowledges that options to address the issues related to the financial system need to take account of the Government's broader policy objectives.

The Inquiry has made the following observations about the superannuation system:

- There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system.
- If allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial systems.
- Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.

## Context

### Australia's retirement income system

The architecture of the retirement income system, which includes the superannuation system, has considerable strengths. Australia's Future Tax System Review endorsed Australia's three-pillar retirement income system (Figure 4.1).<sup>1</sup> Submissions identify the following strengths of the system:

- **Increasing retirement incomes** – the system is improving retirement incomes for many people. It has provided positive real returns over time<sup>2</sup> although during the global financial crisis (GFC) many members nearing retirement were affected by significant declines in wealth. Returns reflect the investment risk borne by members as a result of large allocations to higher-growth but riskier assets.
- **Choice** – the superannuation system delivers significant choice and diversity of fund structure. This includes investment options for those who want them and default options for the less engaged.
- **Funding Australia's economy** – the superannuation sector is a major source of funding for the rest of the economy, including banks and non-financial corporates. Given the long-term nature of its funds, the superannuation sector provides diversity, depth and stability to the financial system. The Financial Services Council (FSC) notes: "By maximising returns to superannuation fund members as required by legislation trustees of superannuation funds are also maximising returns to the Australian economy".<sup>3</sup>

The 2013 Melbourne Mercer Global Pension Index ranked Australia's pension system third out of 20 countries. Australia's system was categorised as having "a sound

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1 Commonwealth of Australia 2009, *Australia's Future Tax System – The retirement income system: Report on strategic issues*, Commonwealth of Australia, Canberra.

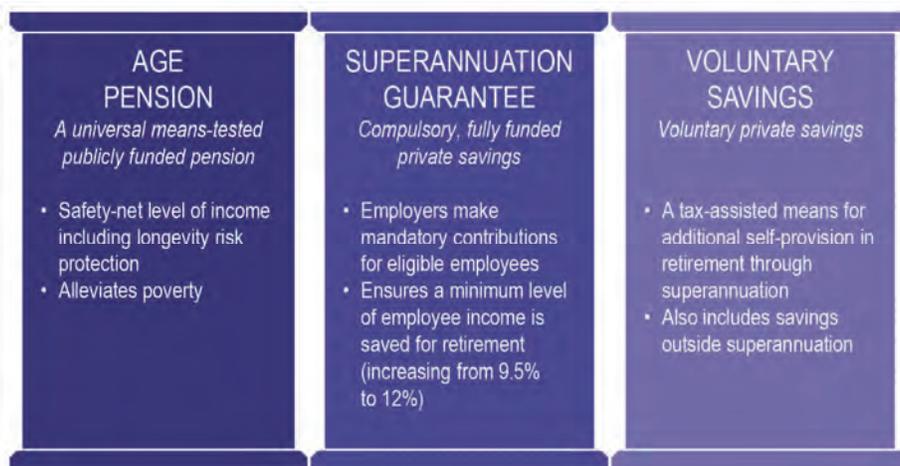
2 Australian Prudential Regulation Authority (APRA) data of large funds shows the average rate of return, net of all expenses and taxes, was 5.4 per cent per annum over the 17 years to June 2013. Association of Superannuation Funds of Australia (ASFA) shows returns after taxes and fees were 6 per cent per annum over the 15 years to June 2013 (3.1 per cent above Consumer Price Index (CPI)) and 7.2 per cent over 20 years (4.5 per cent above CPI) for funds which are representative of the average default investment arrangement. APRA 2013, *Annual Superannuation Bulletin*, June ed., revised February 2014, APRA, Sydney; APRA 2011, *Annual Superannuation Bulletin*, June ed., APRA, Sydney; and ASFA 2014, First round submission to the Financial System Inquiry.

3 Financial Services Council (FSC), First round submission to the Financial System Inquiry, Chapter 1, page 17.

structure, with many good features, but ... some areas for improvement”.<sup>4</sup> Mercer notes that a major area for improvement relates to the retirement phase, which is addressed in the *Retirement incomes* chapter.<sup>5</sup>

The vast majority of superannuation accounts are held in defined contribution schemes. These schemes, unlike employer-sponsored defined benefit schemes that were popular in the past, insulate members from the risks of potential fund insolvency arising from employer bankruptcy. However, they expose individuals to other risks, including investment, inflation and longevity risks.

**Figure 4.1: Australia’s three-pillar retirement income system**



### Objectives of the retirement income system

There is no legislative or formal statement of the guiding objectives for the retirement income system. However, Australia’s Future Tax System Review proposed the following objectives:

- **Broad and adequate** – to protect those unable to save against poverty in their old age and provide the means by which individuals must or can save for their retirement.
- **Acceptable** – to consider the income needs of individuals, both before and after retirement, to be equitable and not to bias saving decisions inappropriately.

4 Mercer 2013, *Melbourne Mercer Global Pension Index*, Australian Centre for Financial Studies, Melbourne.

5 Mercer 2013, *Melbourne Mercer Global Pension Index*, Australian Centre for Financial Studies, Melbourne.

- **Robust** — to deal appropriately with investment, inflation and longevity risk.
- **Simple and approachable** — to allow individuals to make decisions that are in their best interests.
- **Sustainable** — to be financially sound into the future and detract as little as possible from economic growth.<sup>6</sup>

## Major changes since the Wallis Inquiry

Superannuation assets are around six times their level in 1997 and are now over \$1.8 trillion.<sup>7,8</sup> Australia has the fourth largest pool of superannuation assets in the world and is one of only a few countries with pension assets worth more than annual Gross Domestic Product (GDP).<sup>9</sup> Superannuation is the financial system's second largest sector after banking and is growing rapidly, principally due to Government policy settings.

The superannuation sector's landscape has changed markedly since the Wallis Inquiry (see Chart 1.2 in the *Overview* chapter). Between June 1997 and March 2014, the number of funds regulated by Australian Prudential Regulation Authority (APRA), excluding small APRA funds (SAFs), fell from more than 4,700 to 299.<sup>10, 11</sup> This consolidation has largely been driven by the decline in the number of corporate funds.

Assets held in self-managed superannuation funds (SMSFs) have expanded rapidly relative to the rest of the superannuation system. They are now more than 15 times their level in 1997 and have more than one million members.<sup>12, 13, 14</sup> SMSFs currently

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6 Commonwealth of Australia 2009, *Australia's Future Tax System Review, The retirement income system: Report on strategic issues*, Commonwealth of Australia, Canberra.

7 Australian Prudential Regulation Authority (APRA) 2007, *Insight: Celebrating 10 years of superannuation data collection 1996–2006*, Issue 2, Special Ed., APRA, Sydney.

8 Australian Prudential Regulation Authority (APRA) 2014, *Statistics: Quarterly superannuation performance (interim edition)*, March ed., APRA, Sydney.

9 Towers Watson 2014, *Global Pension Asset Study*, January, viewed 24 June 2014, <<http://www.towerswatson.com/en-AU/Insights/IC-Types/Survey-Research-Results/2014/02/Global-Pensions-Asset-Study-2014>>, page 5. Note: refers to 2012 data, in absolute terms.

10 Australian Prudential Regulation Authority (APRA) 2007, *Insight: Celebrating 10 years of superannuation data collection 1996–2006*, Issue 2, Special Ed., APRA, Sydney.

11 Australian Prudential Regulation Authority (APRA) 2014, *Statistics: Quarterly superannuation performance (interim edition)*, March ed., APRA, Sydney.

12 Note: 'Small funds' is used as a proxy for SMSFs in 1997. Australian Prudential Regulation Authority (APRA) 2007, *Insight: Celebrating 10 years of superannuation data collection 1996–2006*, Issue 2, Special Ed., APRA, Sydney; Australian Prudential Regulation Authority 2014, *Statistics: Quarterly superannuation performance (interim edition)*, March, APRA, Sydney.

13 Australian Prudential Regulation Authority 2014, *Statistics: Quarterly superannuation performance (interim edition)*, March ed., APRA, Sydney.

account for around one-third of total superannuation assets, or \$559 billion, compared to 11 per cent of assets in the superannuation system in 1997.<sup>15, 16</sup>

## Efficiency

The efficiency of the superannuation system can be explored in a number of ways. This chapter examines both its operational efficiency – that is, the costs of the system and the after-fee returns it delivers to members – and the extent to which funds are invested to meet members’ needs over their lifecycle.

Large superannuation funds generally hold diversified and professionally managed portfolios of assets. As superannuation funds are a large part of the financial system, the system’s operational efficiency has important implications for productivity in the broader economy.

## Preliminary assessment

### Observation

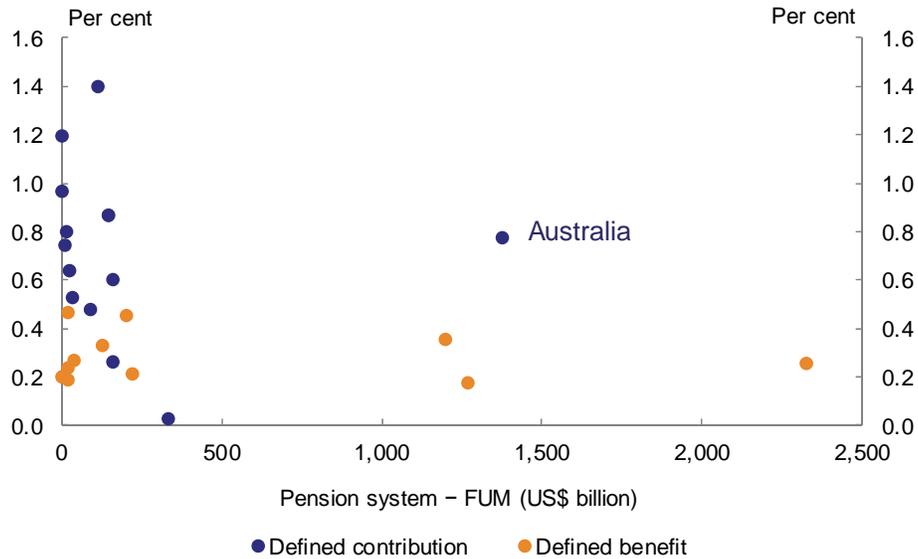
There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system.

The operating costs of Australia’s superannuation funds are among the highest in the Organisation for Economic Co-operation and Development (OECD), and the Super System Review concluded superannuation fees were “too high”.<sup>17, 18</sup> The Grattan

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- 14 Australian Taxation Office (ATO) 2014, *Self-managed super fund statistical report – March 2014*, ATO, viewed 25 June 2014, <<https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Quarterly-reports/Self-managed-super-fund-statistical-report---March-2014/>>.
  - 15 Australian Prudential Regulation Authority (APRA) 2007, *Insight: Celebrating 10 years of superannuation data collection 1996–2006*, Issue 2, Special Ed., APRA, Sydney; Australian Prudential Regulation Authority 2014, *Statistics: Quarterly superannuation performance (interim edition)*, March ed., APRA, Sydney.
  - 16 Australian Prudential Regulation Authority (APRA) 2014, *Statistics: Quarterly superannuation performance (interim edition)*, March ed., APRA, Sydney.
  - 17 OECD 2013, *Pensions at a Glance 2013: OECD and G20 Indicators*, OECD Publishing, viewed 24 June 2014, <[http://dx.doi.org/10.1787/pension\\_glance-2013-en](http://dx.doi.org/10.1787/pension_glance-2013-en)>.
  - 18 Commonwealth of Australia 2010, *Super System Review Final Report, Part One, Overview and Recommendations*, Commonwealth of Australia, Canberra, page 7.

Institute estimates fees have consumed more than a quarter of returns since 2004.<sup>19</sup> Although the Inquiry notes the difficulties of comparing costs or fees across funds, especially internationally, the evidence suggests there is scope to reduce costs and improve after-fee returns (see Chart 4.1). The Inquiry is investigating the costs and fees of the system further.

**Chart 4.1: International comparison of superannuation (pension) expenses**  
Annual expenses, as a percentage of funds under management (FUM)



Source: Grattan Institute.<sup>20,21</sup>

Fees can significantly affect retirement incomes. The Super System Review found that reducing fees by around 40 per cent – or 38 basis points<sup>22</sup> – for the average member would increase their superannuation balance at retirement by approximately \$40,000 (or 7 per cent).<sup>23</sup>

19 Minifie, J, Cameron, T and Savage, J 2014, *Super sting: how to stop Australians paying too much for superannuation*, Grattan Institute, Victoria, page 9.

20 For the purpose of this chart, ‘defined benefit’ is a system where more than 60 per cent of assets are in defined benefit plans; others are allocated to defined contribution.

21 Minifie, J, Cameron, T and Savage, J 2014, *Super sting: how to stop Australians paying too much for superannuation*, Grattan Institute, Victoria, page 6.

22 The figure of 38 basis points is based on the estimated reduction in superannuation fees for the average member from a combination of MySuper and SuperStream initiatives.

23 Commonwealth of Australia 2010, *Super System Review Final Report, Part One, Overview and Recommendations*, Commonwealth of Australia, Canberra. Based on Treasury estimates, assuming 37 years in the workforce.

Fees are also important for the amount of funds available for long-term capital formation. As a guide, a 38 basis point reduction in average fees for the entire superannuation sector would deliver a total saving to members, and additional funds to invest, of around \$7 billion per annum.

That said, fees should not be considered in isolation. It is important that a focus on fees alone does not result in a shift towards lower-cost and lower-return asset allocations that would reduce after-fee returns. Ultimately, superannuation funds should be judged on their after-fee return for a given risk profile.

These issues are not unique to Australia. According to the Squam Lake Working Group, which is a distinguished group of academics:

*High-fee funds argue that their fees are justified by superior performance. A large body of academic research challenges that argument. On average, high fees are simply a net drain to investors.<sup>24</sup>*

### Costs, fees and competition

Submissions and other reports identify a range of reasons for high superannuation costs, and hence fees, in Australia.

#### *Asset allocation*

Compared to those in other countries, Australian funds hold more growth assets.<sup>25</sup> They also invest in alternative asset classes, such as private equity and other unlisted investments. These assets tend to be more expensive to manage, but they are also expected to deliver higher after-fee returns for members.

#### *Economies of scale*

Although Australia's superannuation sector is large by international standards and has undergone some consolidation, it remains highly fragmented. There are 299 large APRA-regulated funds and more than 530,000 small funds, which are predominantly SMSFs.<sup>26</sup> The fragmentation is exacerbated by many members having more than one superannuation account.

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24 Council on Foreign Relations 2009, *Regulation of Retirement Saving*, Working Paper, July, Squam Lake Working Group on Financial Regulation, New York, page 4.

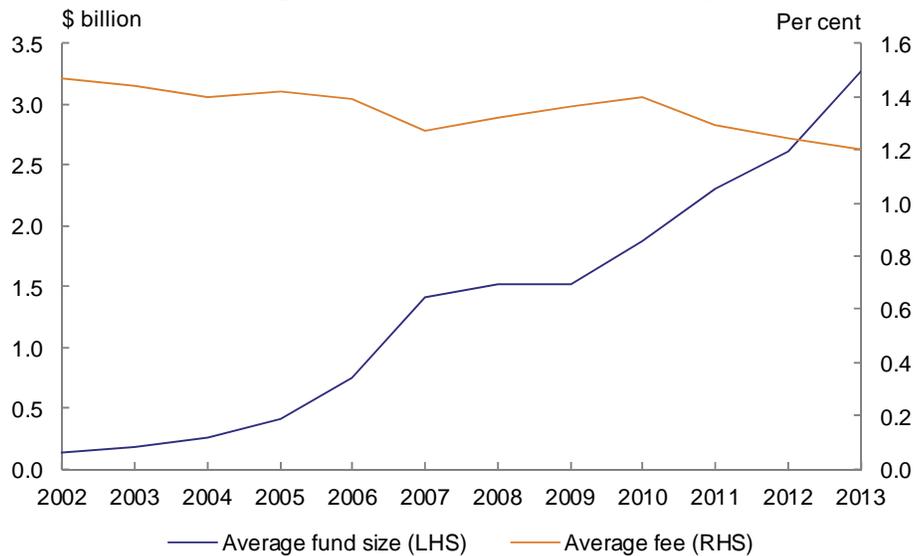
25 OECD 2013, *Pension Markets in Focus*, OECD publishing, viewed 21 June 2014, <<http://www.oecd.org/pensions/PensionMarketsInFocus2013.pdf>>.

26 Australian Prudential Regulation Authority (APRA) 2014, *Statistics: Quarterly Superannuation Performance (Interim Edition)*, March ed., APRA, Sydney.

The Super System Review found that fees had not fallen in line with what could have been expected given the substantial increase in scale (Chart 4.2).<sup>27</sup> This issue is acknowledged in the Industry Super Australia submission:

*This increasing level of economies of scale, coupled with technological advancement and efficiency dividends, should have resulted in a notable fall in the level of fees. This has not been the case.*<sup>28</sup>

**Chart 4.2: Superannuation fund size and average fees**



Note: Average fee data excludes small funds.

Source: APRA<sup>29</sup> and Rice Warner.<sup>30</sup>

Rice Warner estimated that fees fell by around 25 basis points between 2002 and 2013 but a number of offsetting factors have prevented fees from falling further. These include a shift towards investing in higher-cost asset classes, substantial growth in member engagement services and investment in modern administration platforms.<sup>31</sup> The Grattan Institute found the benefits of increased scale over the past decade have

27 Commonwealth of Australia 2010, *Super System Review Final Report, Part One, Overview and Recommendations*, Commonwealth of Australia, Canberra.

28 Industry Super Australia 2014, First round submission to the Financial System Inquiry, page 140.

29 Australian Prudential Regulation Authority (APRA) 2013, *Annual Superannuation Bulletin*, June ed., revised February 2014, APRA, Sydney.

30 Rice Warner 2014, data provided to Financial System Inquiry, 17 June 2014.

31 Rice Warner 2014, *FSC Superannuation Fees Report 2013*, commissioned by the Financial Services Council, Sydney.

been largely offset by higher fund expenses.<sup>32</sup> It is unclear whether this has been translated into higher after-fee returns.

There is an opportunity for fees to fall significantly over time given the further expected increases in scale due to continuing superannuation fund consolidation and growth in superannuation assets.<sup>33</sup> In work commissioned by the Actuaries Institute, Rice Warner predicts the number of funds (excluding small funds) will fall to around 180 over the next five years and adds: “It is conceivable that the number of funds in 30 years will be no more than 20”.<sup>34</sup> Competition between superannuation funds is important for realising these potential fee reductions.

Given the current extent of industry fragmentation, the Inquiry does not have major concerns about the effect of further consolidation in the superannuation market on competition, as long as fees are reduced in line with fund costs. The Super System Review concluded that larger and more efficient funds would be able to lower administration fees.<sup>35</sup> Several submissions note that countries with lower-cost schemes tend to have a smaller number of pension funds.

### Competition

Superannuation funds compete to attract and retain members. Competition between funds for members has largely been conducted on a non-fee basis, which has led to feature-rich and more costly superannuation products.<sup>36</sup> Stakeholders suggest the behaviours of three groups of consumers contributes to this result.

First, a majority of individuals are not actively engaged with the superannuation system and are not sensitive to the fees they are charged by their fund (Box 4.1).<sup>37</sup> In some instances, complex investment structures and layers of investment fees can make it difficult for consumers to understand and compare fee structures across funds. Low

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32 Minifie, J, Cameron, T and Savage, J 2014, *Super sting: how to stop Australians paying too much for superannuation*, Grattan Institute, Victoria.

33 Rice Warner predicts assets will triple in real terms over the next three decades. Rice Warner 2014, *Ageing and capital flows*, research commissioned by the Actuaries Institute, Sydney, and provided to Financial System Inquiry, May 2014.

34 Ibid, page 9.

35 Commonwealth of Australia 2010, *Super System Review Final Report, Part One, Overview and Recommendations*, Commonwealth of Australia, Canberra.

36 The Grattan Institute attributes cost increases to strong competition between funds on non-price factors in a market where consumers may not be price sensitive. See Minifie, J, Cameron, T and Savage, J 2014, *Super sting: how to stop Australians paying too much for superannuation*, Grattan Institute, Victoria.

37 Minifie, J, Cameron, T and Savage, J 2014, *Super sting: how to stop Australians paying too much for superannuation*, Grattan Institute, Victoria.

rates of switching between large funds also contribute to the lack of fee competition.<sup>38</sup> The Super System Review found “the model of member-driven competition through ‘choice of fund’ ... has struggled to deliver a competitive market that reduces costs for members”.<sup>39</sup>

Second, a minority of consumers, who are sensitive to fees and/or to after-fee returns, are able to access lower-fee products by ‘shopping around’. However, these actions have not exerted significant downward pressure on fees for the broader range of products available.<sup>40</sup>

Third, a large number of individuals have established SMSFs. APRA-regulated superannuation funds compete to retain members by offering product features that give individuals more choice and control. Members can access a broad range of products and services, some of which provide individuals with substantially more flexibility to tailor their investment allocation.

To address the lack of member-driven competition, the Super System Review recommended introducing a low-cost product — MySuper — to replace existing default funds. MySuper also introduces consistent disclosure requirements to address some of the issues listed in Box 4.1. A broader discussion about financial product disclosure is in the *Consumer outcomes* chapter.

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38 A Roy Morgan Research report, based on approximately 30,000 interviews each year with members of superannuation funds, shows rates of switching between superannuation funds in the range of 2 to 5 per cent since 2005, when Super Choice legislation was introduced. Approximately 42 per cent of people moved to a new fund because they changed employers. Roy Morgan Research 2013, *Superannuation and Wealth Management in Australia*, Report, December 2013.

39 Commonwealth of Australia 2010, *Super System Review Final Report, Part One, Overview and Recommendations*, Commonwealth of Australia, Canberra, page 8.

40 Minifie, J, Cameron, T and Savage, J 2014, *Super sting: how to stop Australians paying too much for superannuation*, Grattan Institute, Victoria.

**Box 4.1: Why hasn't competition delivered optimal outcomes already?**

**Failure to exercise choice:** Often a member does not choose the fund to which they belong. New employees typically become a member of their employer's default fund.

**Lack of price awareness:** Compulsory contributions do not come directly out of members' pockets, nor do the fees and other costs charged by the fund – at least not until they retire. This makes people much less price aware and much less likely to make a decision based on price or cost.

**Lack of interest:** Members are often not engaged with their superannuation until closer to retirement, so will not be sufficiently interested to respond to competitive behaviour on the part of funds until that time – if at all.

**Agency and structural issues:** There are limited opportunities for member vigilance or incentives for agency vigilance to reduce prices.

**Complexity:** Superannuation is inherently complex, and many consumers do not feel confident making decisions about it.

**Lack of comparability:** Even if members are engaged, contestability is weak at consumer level. This is because of product complexity and the lack of information and transparency about fees and performance.

**Frictions:** Even if members are interested in switching funds, often the paperwork and other 'frictions' in changing funds become too big a disincentive and they give up.

Source: Super System Review.<sup>41</sup>

Superannuation funds also attract members by being the default fund for mandatory employer contributions. Funds compete to be the default fund for large corporates, while many modern awards prescribe the employer's default fund. Submissions raise competition for default fund status in awards as a major issue. The selection of default funds in awards largely reflects precedent and is not subject to a competitive process. Several submissions propose expanding award eligibility to all approved MySuper products to increase competition between funds.

The costs of superannuation funds, and the features they offer to members, are affected by the degree of competition among those providing services to the funds. This includes fund managers competing for superannuation fund clients, fund managers competing for access to platforms, and platforms competing to attract advisers. A trend in the wealth management sector is towards more vertical integration. Although

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<sup>41</sup> Commonwealth of Australia 2010, *Super System Review Final Report, Part One, Overview and Recommendations*, Commonwealth of Australia, Canberra, page 7.

this can provide some benefits to members of superannuation funds, the degree of cross-selling of services may reduce competitive pressures and contribute to higher costs in the sector.

### *Effectiveness of MySuper and SuperStream*

The Super System Review estimated that introducing MySuper and SuperStream would reduce superannuation fees for the average MySuper member by around 40 per cent (or 38 basis points) in the long run.<sup>42, 43</sup>

However, views on the likely effectiveness of these reforms to reduce costs and fees are mixed. Over the next few years, Rice Warner expects MySuper will cause average annual fees across the sector to converge to 1 per cent of assets from 1.12 per cent in 2012–13.<sup>44</sup> In contrast, the Grattan Institute argues MySuper will do little to force fees down. It also contends that, although SuperStream will reduce some costs, it will not address the costs of marketing, sales or asset management.<sup>45</sup> On balance, the Inquiry considers it too early to assess whether these reforms will achieve their objectives.

### *Regulation and insurance*

Several submissions highlight the costs of regulation in reducing member returns. Mercer and the Association of Superannuation Funds of Australia (ASFA) cite the costs of complying with legislation, which Mercer notes “are inevitably passed on to the members”.<sup>46, 47</sup> Mercer also suggests that disclosure requirements, which put too much emphasis on fees, encourage trustees to adopt lower-cost investment strategies, which may not have high after-fee returns.<sup>48</sup>

Stakeholders also cite the direct costs to funds from developing MySuper products and getting approval from APRA and the Fair Work Commission for listing them in modern awards. These costs are passed on to MySuper members through higher fees. Implementing SuperStream also has costs, such as investing in modern administration platforms. However, since this aims to remove inefficiencies, such as manual data processing, funds can expect to recoup these costs over time. The costs of prudential regulation are discussed further in the *Regulatory architecture* chapter.

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42 Commonwealth of Australia 2010, *Super System Review Final Report, Part One, Overview and Recommendations*, Commonwealth of Australia, Canberra.

43 SuperStream is designed to improve administrative efficiency.

44 Rice Warner 2014, *FSC Superannuation Fees Report 2013*, commissioned by the Financial Services Council, Sydney.

45 Minifie, J, Cameron, T and Savage, J 2014, *Super sting: how to stop Australians paying too much for superannuation*, Grattan Institute, Victoria.

46 Mercer 2014, First round submission to the Financial System Inquiry, page 28.

47 Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry.

48 Mercer 2014, First round submission to the Financial System Inquiry.

One submission also notes that fees charged for insurance within superannuation funds could reduce retirement savings. However, superannuation funds (excluding SMSFs) generally provide low-cost and sometimes tax-advantaged access to life, disability and income protection insurance, which provides net benefits to a broad range of people.

Trust law forms the basis for the governance of superannuation. The Inquiry seeks views on whether the trust structure is best placed to meet the needs of all members in a cost-effective manner.

### *Member investment switching*

Member investment switching contributes to higher fees and may be inefficient when not properly priced by funds.

Many funds allow members to change their investment allocation frequently, often at short notice and generally at low or no cost to the member. Although member engagement should be encouraged, this behaviour can add to fund costs due to the need to rebalance investment allocations in the short term. It can also affect member returns by increasing the need for funds to hold liquid assets. The demand for liquidity is discussed below.

Member investment switching can also result in a majority of fund members subsidising the cost of investment switches by a minority. This occurs where funds do not charge members the full cost of investment switching or as a result of timing lags on asset valuations.

### *Active investment management*

Some submissions argue active investment strategies contribute to superannuation fund costs and fees. This is discussed in detail below.

### *Short-termism*

Some submissions question whether a trend towards chasing short-term returns is affecting asset allocations and contributing to lower after-fee returns in Australia.

The attention paid to quarterly superannuation return ‘league tables’, particularly by the industry itself, is cited by stakeholders as one explanation for superannuation funds targeting short-term returns and employing active asset managers. Understandably, funds and fund managers want to perform well relative to their peers for competitive reasons.

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However, the publication of short-term returns is less useful for members as an indicator of future fund performance. According to the Squam Lake Working Group:

*A large body of research finds that past returns in general, and short-term returns in particular, are almost useless in forecasting subsequent investment performance.<sup>49</sup>*

Stakeholders also raise concerns that short-term behaviour is likely to lead to a more homogenous asset allocation across funds.

The effect of short-term investment behaviour on long-term outcomes is unclear. The Squam Lake Working Group argues that short-term behaviour by some funds will create opportunities for others:

*There seems enough evidence to support a case that the balance is tilted at least a little too far towards the short-term, with potential adverse implications for market efficiency, volatility, corporate myopia and the efficiency of financial intermediation. However, to the extent that the balance is indeed tipped too far, this will create opportunities for those capable of adopting a longer horizon.<sup>50</sup>*

### *Active investment management*

Many funds adopt active management of superannuation assets in the pursuit of higher returns. Active management can often involve frequent adjustment to the investment portfolio in an attempt to outperform the market, particularly over shorter horizons. However, the costs of active management, including transaction costs and management fees, are widely acknowledged:

*High turnover is also a drag on average returns because it creates high transactions costs.<sup>51</sup>*

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49 Council on Foreign Relations 2009, *Regulation of Retirement Saving*, Working Paper, Squam Lake Working Group on Financial Regulation, New York.

50 Warren, G 2014, *Long-term investing: What determines investment horizon?*, Centre for International Finance and Regulation Research Working Paper No. 024/2014.

51 Council on Foreign Relations 2009, *Regulation of Retirement Saving*, Working Paper, Squam Lake Working Group on Financial Regulation, New York.

According to the Grattan Institute, active management of superannuation assets increases costs but not after-fee average returns in the sector.<sup>52</sup> It is very difficult for the superannuation system as a whole to beat the market over the long run within an asset class, although it is possible for an individual fund to do so. As Nobel Laureate William Sharpe noted:

*Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs.*<sup>53</sup>

Rice Warner estimates fee differences of around 45 basis points between those MySuper funds for which less than 25 per cent of the portfolio is actively managed and those for which more than 75 per cent of the portfolio is actively managed.<sup>54</sup> That said, some of these fee differences may be explained by differences in asset allocation.

Rice Warner also presents evidence that some smaller industry funds have increased their proportion of passively managed assets to reduce costs and notes that retail funds have designed a range of MySuper products with significantly different levels of active management.<sup>55</sup>

### *Lifecycle investment*

The time horizon of superannuation fund investments could be better tailored to individual members.

A well-functioning and efficient superannuation system would be expected to invest to maximise returns over a horizon that reflects the demographics of its members. This approach would not only benefit members but may also improve the funding of long-term capital formation.

Anecdotal evidence suggests a trend towards a ‘lifecycle investment’ approach in MySuper products; under this approach, funds are heavily invested in growth assets for younger members and invested more defensively as a member advances in age. This approach would reduce the risk of substantial falls in superannuation balances for people close to retirement, which occurred during the GFC. Superannuation funds have more information about their members than their age, including gender, contribution patterns and superannuation balance. There may be benefits in tailoring

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52 Minifie, J, Cameron, T and Savage, J 2014, *Super sting: how to stop Australians paying too much for superannuation*, Grattan Institute, Victoria.

53 Sharpe, W F 1991, ‘The Arithmetic of Active Management’, *The Financial Analysts’ Journal*, Volume 47, No. 1, CFA Institute, USA, pages 7–9.

54 Rice Warner 2014, *FSC Superannuation Fees Report 2013*, commissioned by the Financial Services Council, Sydney, page 13.

55 Rice Warner 2014, *FSC Superannuation Fees Report 2013*, commissioned by the Financial Services Council, Sydney, page 13.

asset allocation to members by asking members for more information, including about their retirement goals and risk preferences.

The current focus of large superannuation funds is on maximising the balance at the point of retirement. DFA Australia (Dimensional) argues the focus should be on maximising income in retirement: “Sustainable income flow, not the stock of wealth, is the objective that counts for retirement planning”.<sup>56</sup> This would involve a fundamental change to the approach to asset management.

For example, the value of an inflation-indexed bond, if viewed as an asset to be marked to market every day, can be very volatile. In contrast, if viewed as a source of regular income, it provides stable inflation-protected cash flows for its life. For assets that are expected to be held to maturity, the book value may be a more appropriate measure of the asset value to members.

The current focus on lump sum balances is evident from the absence of retirement income projections from annual statements sent to members. For many people, income projections, while difficult to calculate, would be far more useful than total accrued balances.

The Inquiry is interested in views and evidence on whether funds are excessively focused on delivering short-term returns, whether this is a significant issue, how it could be addressed, and to what extent more tailoring of asset allocation to members would produce net benefits for members.

## Liquidity management

A number of submissions highlight the demand for liquid assets by superannuation funds as a major issue for this Inquiry. The GFC tested the liquidity management of funds, which, along with the subsequent introduction of prudential standards, has raised superannuation funds’ awareness of the need for better liquidity management frameworks.

All funds need liquidity to deal with a range of scenarios. However, if superannuation funds hold more liquid assets than needed, this may lower after-fee returns to members.

The major drivers of the demand for liquid assets by superannuation funds are:

- **The need to make benefit payments** – demand for more liquid assets will increase over time as more members retire with larger balances and the ratio of inflows to

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<sup>56</sup> DFA Australia (Dimensional) 2014, First round submission to the Financial System Inquiry, page 16.

outflows falls. Currently, inflows are substantially larger than outflows. However, this change is largely predictable. Superannuation funds should be able to adjust their asset portfolios accordingly.

- **The portability of superannuation benefits between funds** – demand for liquidity is higher because of the requirement for funds to action member requests to transfer their benefits to another fund within three business days, although this is extendable to up to 90 days in some circumstances. Funds must therefore provision for significant member movement despite the low risk of this occurring. Given that inter-fund transfers remain in the superannuation system, requiring each fund to provision for member movements results in the sector collectively holding more liquid assets than it needs. Funds can apply to APRA to extend the time period for portability. However, funds may be concerned about the reputational consequences from making such a request.
- **The need to maintain target asset allocations within a fund** – when asset allocations fall outside a superannuation fund’s internally set target ranges, the portfolio needs to be rebalanced. Superannuation funds should allow themselves sufficient time to rebalance assets, in part through member contributions, over a time horizon that is in the best interests of members.
- **The need to cover margins on currency hedging positions** – superannuation funds invest in international assets and seek to limit their exposure to currency fluctuations. ASFA notes that funds generally hedge half their international currency exposures.<sup>57</sup> When the Australian dollar depreciates, funds are required to cover margin calls.
- **Member investment switching** – as discussed above, when a member elects to change how their superannuation benefits are invested, funds need liquidity to adjust the member’s portfolio. However, the timing of this switching may not reflect the liquidity characteristics of the assets being bought and sold. Although only a small minority of superannuation members switch their investment allocation regularly, at times members will react concurrently and shift their asset allocation in the same direction. This was particularly evident during the GFC, when members increased allocations to more defensive assets.<sup>58</sup> Given older members (with higher balances) are more likely to change their asset allocations than younger members, the need for liquidity to manage this risk may increase over time as the population ages.<sup>59</sup>

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57 Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry.

58 Industry Super Australia 2014, First round submission to the Financial System Inquiry.

59 Industry Super Australia 2014, First round submission to the Financial System Inquiry.

## Policy options for consultation

A number of options for reducing fees and increasing after-fee returns are outlined below.

### Fees

#### *Competition and default funds*

It is too early to assess the effectiveness of MySuper reforms in stimulating competition and improving after-fee returns for default fund members. MySuper only replaced default superannuation products for new accounts from 1 January 2014, and superannuation funds have until 1 July 2017 to transfer balances of members in existing default funds into a MySuper account. There has been a substantial cost to industry in establishing MySuper products.

The Productivity Commission recommends introducing more competition in relation to default employer contributions through changing awards.<sup>60</sup> The Government is currently considering policy options on this issue.<sup>61</sup>

Other mechanisms could also be deployed to drive fees down. One example is the approach introduced in Chile in 2008, where – unlike Australia – superannuation contributions of all new members are placed in the same default fund. Default fund management is auctioned on the basis of fees, creating stronger competition between funds for default fund status. Since these arrangements started, the fees charged by successful bidders in Chile have fallen by 65 per cent, although fees on other funds have not fallen to the same degree.<sup>62</sup> This policy option raises a number of other policy issues that would need to be considered before being contemplated for Australia, such as the number of default funds, concentration risk, asset allocation and regulation.

#### *Member investment switching*

Proper pricing of investment switching would result in more efficient outcomes for the sector and more equitable outcomes for members. Superannuation funds could be encouraged to price and schedule investment switching appropriately, so the costs of switching are not imposed on other members of the fund. The timing of an investment switch should reflect the benefits to all members of giving effect to investment switching after all assets of the fund have been revalued. NAB notes: “As highlighted

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60 Productivity Commission 2012, *Default Superannuation Funds in Modern Awards*, Report No. 60, Final Inquiry Report, Productivity Commission.

61 For further detail, see the consultation paper released by the Government in November 2013, *Better regulation and governance, enhanced transparency and improved competition in superannuation*, Commonwealth of Australia, Canberra.

62 Berstein Jáuregui, S (ed) 2010, *El Sistema Chileno de Pensiones*, Superintendencia de Pensiones, Santiago .

by the GFC, funds which held illiquid assets and used infrequent crediting rates exposed members to intra-fund member arbitrage”.<sup>63</sup>

## Liquidity

ASFA notes the need “to reassess the ways in which we require superannuation funds to manage liquidity risk, potentially exploring innovative solutions to this issue”.<sup>64</sup>

### *Liquidity facility*

Some stakeholders argue for APRA-regulated superannuation funds to have access to a liquidity facility at the Reserve Bank of Australia (RBA). This facility would both provide superannuation funds with reliable access to liquidity during times of stress and increase their capacity to invest for the long term.

The Inquiry notes that to access the RBA liquidity facility, superannuation funds would need to hold repo-eligible assets, which tend to be highly liquid. It is therefore unclear how access to such a facility would reduce holdings of liquid assets by superannuation funds. The Inquiry also notes that superannuation funds can compete indirectly for liquidity at the RBA through an entity that already participates in the open market operations of the RBA, as long as the fund has eligible assets to exchange with this entity. Alternatively, superannuation funds can participate directly in open market operations by becoming a member of the Reserve Bank Information and Transfer System (RITS) and holding their liquid assets in Austraclear.

The Inquiry is not convinced that access to a liquidity facility at the RBA would overcome the concerns raised in submissions.

### *Portability requirements*

Stakeholders note a longer maximum time period for portability transfers could be legislated. This could include allowing trustees to transfer member balances in stages, based on the liquidity characteristics of a member’s underlying asset allocation. A longer time frame would apply for illiquid assets compared to liquid assets. ASFA believes the relaxation of liquidity requirements could apply to “products that are mainly invested in by younger members with longer investment horizons”.<sup>65</sup> Implementing a time-sequenced approach raises other issues. For example, members with assets split between two funds during the transfer period will potentially incur additional fees.

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63 NAB 2014, First round submission to the Financial System Inquiry, page 18.

64 Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry, page 42.

65 Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry, page 42.

The regulator could also extend the maximum portability time period for the entire industry — as opposed to individual funds, which currently occurs — during times of financial stress. This could reduce the need for the sector as a whole to hold higher levels of liquidity for intra-sector transfers. It may also mitigate the reputational risk of individual funds applying for an extension of time to transfer funds.

A principles-based approach to portability transfers may be more effective than the current prescriptive approach. The Actuaries Institute believes principles-based regulation is better equipped than prescription-based regulation to respond to the broader societal changes occurring. Under a principles-based approach, superannuation funds could be required to make portability transfers in a timely and efficient manner and could report to the regulator on the time it takes to effect portability requests. The regulator could then deal with any funds that were not implementing requests in a timely manner. However, without an objective benchmark with which to judge the amount of time to complete a transfer to another superannuation fund, this approach may create more ambiguity for all parties involved, including the regulator.

There is a trade-off between the desire for greater competition in the superannuation sector and the desire for funds to be invested for the long term. However, there is little evidence that portability is currently generating competition between funds.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements and review the effectiveness of the MySuper regime in due course.
- Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.
- Replace the three-day portability rule:
  - With a longer maximum time period or a staged transfer of members' balances between funds, including expanding the regulator's power to extend the maximum time period to the entire industry in times of stress.
  - By moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach.

*The Inquiry seeks further information on the following areas:*

- Does, or will, MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns? What are the costs and benefits of auctioning the management rights to default funds principally on the basis of fees for a given asset mix? Are there alternative options?
- Is the recent trend of greater vertical integration in the wealth management and superannuation sectors reducing competitive pressures and contributing to higher superannuation fees? Are there mechanisms to ensure the efficiency of vertical integration flow through to consumers?
- Are there net benefits in tailoring asset allocation to members and/or projecting retirement incomes on superannuation statements?
- Is there an undue focus on short-term returns by superannuation funds? If this is a significant issue, how might it be addressed?
- To what extent is there a trend away from active asset management within asset classes in superannuation funds? Is this a positive or negative development for members?
- How could funds price switching properly and take into account differences in liquidity between asset classes?
- Could other arrangements be developed to facilitate asset transfers between funds when members switch? Do funds require additional mechanisms to manage liquidity beyond the need for liquidity for portability and member investment switching?
- Is the trust structure best placed to meet the needs of members in a cost-effective manner?

## Leverage

The use of leverage in superannuation funds to finance asset purchases is embryonic but growing. The proportion of SMSFs with borrowings increased from 1.1 per cent in 2008 to 3.7 per cent in 2012. The average amount borrowed increased over this period

from \$122,000 to \$357,000. Total borrowings in 2012 were over \$6.2 billion.<sup>66</sup> More recently, Investment Trends research found that, over the year to April 2014, the number of SMSFs using geared products increased by more than 11 per cent to 38,000.<sup>67</sup> Leverage in APRA-regulated funds is small, with total borrowings of under \$2 million reported each quarter over the past year.<sup>68</sup>

## Preliminary assessment

### *Observation*

If allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial systems.

Leverage is widespread across the financial system and magnifies risk on both the upside and downside. In superannuation, direct leverage, other than to address very-short-term cash flow and liquidity needs, was originally prohibited to reduce the risk to retirement incomes but has since been incrementally permitted.<sup>69</sup> In 2007, the *Superannuation Industry (Supervision) Act 1993* (SIS Act) was modified to allow all superannuation funds to borrow with the primary intent to legitimise investing in instalment warrants, which have embedded leverage. Further amendments in 2010 clarified the terms of this borrowing.

The GFC highlighted the benefits of Australia's almost entirely unleveraged superannuation sector. The general absence of direct leverage in superannuation funds meant that losses were not magnified. This enabled the superannuation sector to have a stabilising influence on the financial system. A clear example of this was the amount of equity funding the sector provided to the banking system in 2009. This was beneficial for superannuation fund members, taxpayers, the financial system and the economy.

The ability of funds to borrow may, over time, erode this strength and could contribute to systemic risks to the financial system. For example, a fund with directly leveraged exposure to asset price volatility may have to post margins if asset prices fall. If many

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66 Australian Taxation Office (ATO) 2013, *Self-Managed Super Funds: A statistical overview 2011-2012*, ATO, viewed 24 June 2014, <<https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2011-2012/>>.

67 Investment Trends 2014, *SMSF Investor Report*, April. Note: Based on a survey of 2,163 SMSF trustees.

68 Australian Prudential Regulation Authority 2014, data provided to the Financial System Inquiry, 3 June 2014.

69 Commonwealth of Australia 2010, *Super System Review Final Report, Part Two, Overview and Recommendations*, Commonwealth of Australia, Canberra.

funds are exposed to the same assets, or at least assets with correlated returns, they may be forced to sell some assets to fund these margin calls. This could cause the price of the assets to fall further and potentially trigger a downward spiral, which could have flow-on effects to other parts of the financial system. Moreover, it could compromise the superannuation system's ability to provide adequate incomes in retirement and transfer risk to the Government in the form of higher Age Pension outlays.

Some evidence also suggests that borrowing in superannuation is often associated with poor financial advice. For example, an Australian Securities and Investments Commission (ASIC) review of over 100 selected investors' files found that much of the poor advice on setting up SMSFs provided by financial advisers and accountants related to establishing an SMSF as part of a geared investment strategy.<sup>70</sup> This Inquiry shares the Super System Review Panel's view that leverage should not be a core focus of SMSFs – or any superannuation fund – and is inconsistent with Australia's retirement income policy.<sup>71</sup>

## Policy options for consultation

The general prohibition on borrowing in superannuation was introduced for sound reasons. Although levels of direct leverage in the superannuation sector are low, they are increasing. Removing direct leverage in superannuation is consistent with the concept that superannuation tax concessions should apply to funds that have been saved and not borrowed. There are ample opportunities – and tax benefits – for individuals to borrow outside superannuation.

However, borrowing on a short-term basis to address unexpected liquidity needs is appropriate. This has always been permitted under the SIS Act.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:*

Restore the general prohibition on direct leverage of superannuation funds on a prospective basis.

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70 Australian Securities and Investments Commission (ASIC) 2013, *SMSFs: Improving the quality of advice given to investors*, Report 337, ASIC, Sydney. The majority of files selected to review involved investors with a fund balance of \$150,000 or less and included some, or all, of the following features: older members, low incomes, borrowing and investment in a single asset class.

71 Commonwealth of Australia 2010, *Super System Review Final Report, Chapter 8 – Self-managed super solutions*, Commonwealth of Australia, Canberra.

## Stability of superannuation policy settings

Superannuation policy settings have undergone substantial change since the Wallis Inquiry. Regulation, taxation, legislation, and the development and refinement of broader policy settings have changed frequently (Figure 4.2). Submissions express concern about the frequency of policy changes.

### Preliminary assessment

#### *Observation*

Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.

### Long-term perspective

Constant change in superannuation and retirement income policy settings imposes costs on superannuation funds, which are borne by members. As a long-term savings vehicle, superannuation would benefit from policy stability to build long-term confidence and trust in the system and encourage long-term savings. This theme has been raised in several submissions. For example, AMP argues:

*If the goal of public policy is to maintain confidence in superannuation as a retirement savings vehicle, predictability and stability in policy settings is a must.<sup>72</sup>*

Almost half of individuals surveyed by Investment Trends in the accumulation phase and aged 40 years or older said they were worried about the effect of regulatory changes on their retirement.<sup>73</sup> The Australian Institute of Superannuation Trustees suggests: “A focus on short-term policy change needs to be replaced by a long-term perspective”.<sup>74</sup> Mercer argues: “A more holistic approach is required, taking into account both superannuation and the Age Pension, to make the sort of long-term policy needed to ensure Australians’ retirement security”.<sup>75</sup>

To ensure policy stability, the system needs to achieve, and be seen to achieve, its objectives efficiently and equitably, and the fiscal costs associated with the policy

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72 AMP 2014, First round submission to the Financial System Inquiry, page 8.

73 Investment Trends 2013, *December 2013 Retirement Income Report*. Noted: Based on a survey of 5,730 Australians aged 40 years or older.

74 Australian Institute of Superannuation Trustees 2014, First round submission to the Financial System Inquiry, page 5.

75 Mercer 2013, *Taxation & superannuation: The shortcomings of the superannuation taxation expenditures*, Mercer, Melbourne. Attachment to Mercer’s first round submission to the Financial System Inquiry, 2014.

settings need to be sustainable. However, some submissions, coupled with other evidence provided below, cast doubt over whether current policy settings will stand the test of time.

**Figure 4.2: Timeline of major superannuation policy changes**

MAJOR POLICY DECISIONS		TAXATION SITUATION (a)		
1990		<p>The tax treatment that applied to superannuation from 1990 to 2007 was as follows:</p> <ul style="list-style-type: none"> <li>▪ Contributions taxed at 15%, plus a surcharge between 1997–98 and 2004–05</li> <li>▪ Earnings taxed at 15%</li> <li>▪ Benefits taken as a lump sum taxed at 0% or 15% depending on the amount</li> <li>▪ Benefits taken as an income stream taxed at personal tax rates less a 15% rebate</li> </ul>		
1992	Superannuation Guarantee introduced			
1997	Capital gains tax small business retirement exemption introduced			
1999	Preservation rules strengthened Self-managed superannuation funds regulated by the ATO. Small APRA-regulated funds replace excluded superannuation funds			
2002	Superannuation Guarantee reached 9%			
2003	Government co-contribution introduced			
2005	Transition to retirement pensions introduced			
2007	Tax on superannuation benefits paid from a taxed fund abolished for people aged 60 and over Contributions caps introduced to place limits on the concessionality of superannuation, replacing the previous Reasonable Benefits Limit system		<p>In 2007, the tax treatment of superannuation was changed to the following:</p> <ul style="list-style-type: none"> <li>▪ Contributions taxed at 15%</li> <li>▪ Accumulation earnings taxed at 15%</li> <li>▪ Benefits taken as a lump sum or income stream tax-free for individuals aged 60 and over</li> </ul>	
2009	Concessional contributions cap halved			
2012	One-year payment of up to \$500 for low-income earners to refund tax paid on their contributions			
2013	Superannuation Guarantee age limit abolished Gradual increase in the Superannuation Guarantee from 9% to 12% commenced			<p>From 2012, an additional contributions tax of 15% introduced for individuals earning over \$300,000 per annum</p>
2014	Introduction of MySuper, a low-cost and simple superannuation product, to replace existing default funds Start of SuperStream — electronic data and payments for superannuation			
2016	Gradual increase in the preservation age to 60 commences			
2022	Superannuation Guarantee scheduled to reach 12%			
2024	Preservation age reaches 60			

(a) Broad indication of tax treatment of defined contribution schemes.

Submissions raise whether the superannuation and retirement income systems should have a clearer purpose. Dimensional suggests: “a priority should be to set a clearly defined objective for superannuation”.<sup>76</sup> There may be value in the Government seeking Parliament’s agreement to the objectives of the superannuation and retirement income systems, so any future changes are judged against those objectives. ASFA argues: “at the whole of system level, there should be monitoring to ensure the system is delivering against its retirement objectives”.<sup>77</sup>

### Superannuation tax concessions

As the population ages, the cost to Government of the current retirement income system is likely to be a major source of pressure to change policy settings. To credibly promise superannuation tax concessions in retirement and an adequate Age Pension for those who will need it in the future, a strong Government balance sheet and policy settings that do not disproportionately increase the costs to Government over time are important.

There should be a reasonable expectation that the objectives of the system will be achieved over the longer term. While not conclusive, some evidence raises questions about whether the current policy settings are efficiently targeted and robust.

For example, the large number of individuals with very large superannuation balances suggests the superannuation system is being used for purposes other than providing retirement incomes (Figure 4.3). The large number of accounts with assets in retirement in excess of \$5 million could each receive annual tax concessions more than five times larger than the single Age Pension.<sup>78, 79</sup>

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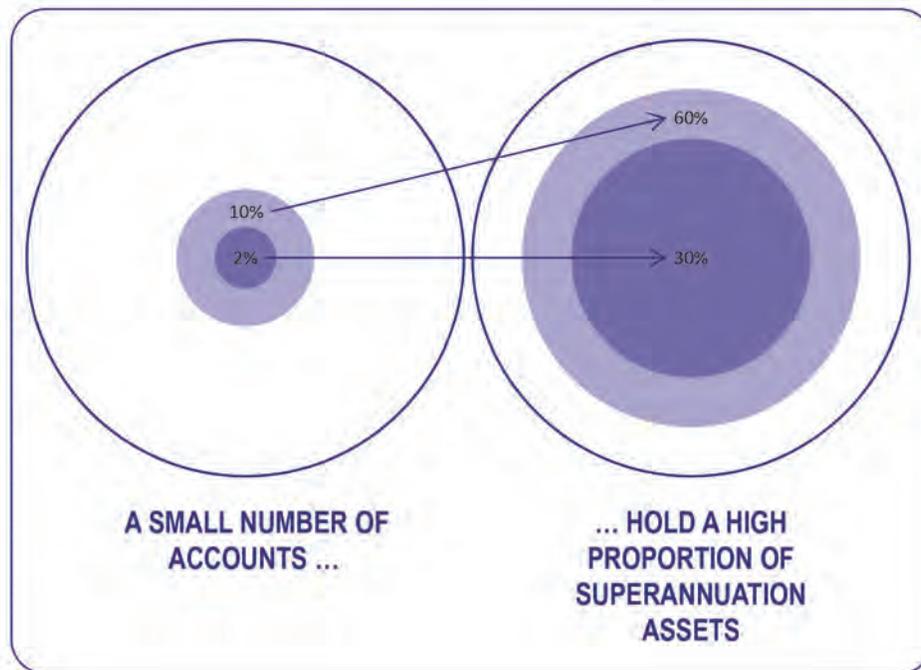
76 DFA Australia (Dimensional) 2014, First round submission to the Financial System Inquiry, page 4.

77 Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry, page 22.

78 The calculations are based on a superannuation account in the retirement phase (0 per cent earnings tax).

79 In June 2012, around 8,500 individuals had balances above \$5 million. Australian Taxation Office (ATO) 2014, *Self-managed super fund statistical report – March 2014*, ATO, viewed 25 June 2014, <<https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Quarterly-reports/Self-managed-super-fund-statistical-report---March-2014/>>.

**Figure 4.3: Superannuation accounts by asset size**



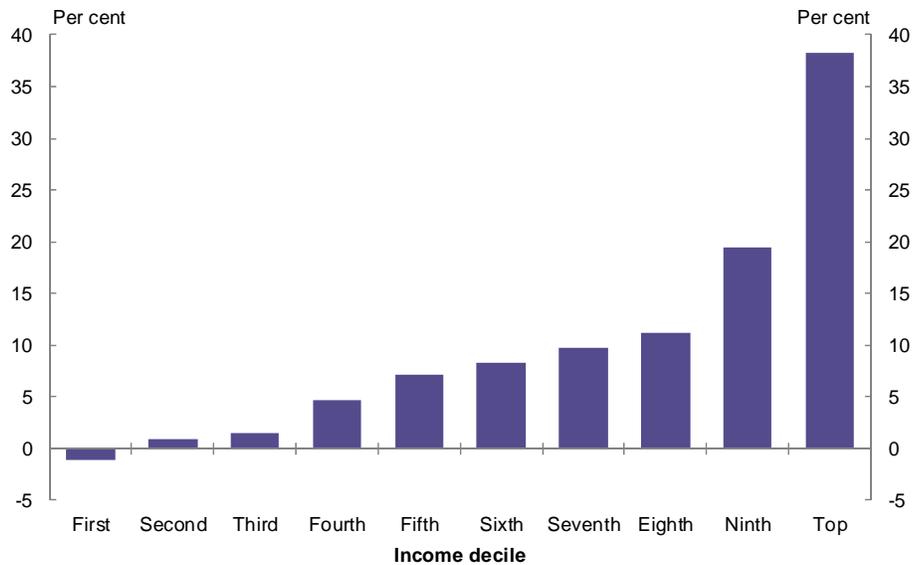
Source: Treasury.<sup>80</sup>

Furthermore, the majority of superannuation tax concessions accrue to the top 20 per cent of income earners (Chart 4.3). These individuals are likely to have saved sufficiently for their retirement, even in the absence of compulsory superannuation or tax concessions. Some stakeholders question whether this is equitable. It is not clear that superannuation tax concessions for this income cohort will significantly reduce future Age Pension costs.

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<sup>80</sup> Treasury 2014, data provided to the Financial System Inquiry, 11 June 2014. Analysis based on de-identified 16 per cent sample of personal income tax and member contribution data for 2011–12, sourced from the ATO. Some caution is required in interpreting these figures due to the larger number of accounts compared to people in the system.

**Chart 4.3: Share of total superannuation tax concessions by income decile**



Source: Treasury.<sup>81</sup> Based on analysis 2009–10 ATO data.

Recent changes to concessional and non-concessional contribution caps and a higher contributions tax rate for very-high-income earners (30 per cent above \$300,000) have attempted to achieve more equitable outcomes. Further adjustments to policy settings may be required.

#### *Imputation credits and tax-free superannuation*

A growing proportion of Australian equities has been, and is expected to be, held in superannuation accounts in retirement. The Inquiry notes that, due to refundable imputation credits and tax-free superannuation in retirement, a growing proportion of company tax collected could be refunded to superannuation funds and retirees over time. Although this is of enormous benefit to retirees, it may erode one of the largest sources of revenue for the Australian Government at the same time expenditure pressures are increasing.

The combination of population ageing and the projected growth in superannuation assets increases the urgency and importance of getting the right policy settings in place. Policy settings should be designed to minimise the need of future governments to change them to maintain confidence and trust in the system. Some of the settings could be considered as part of the Tax White Paper process.

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<sup>81</sup> Treasury 2014, data provided to the Financial System Inquiry, 11 June 2014.

## Self-managed superannuation funds

SMSFs have grown rapidly to become a large share of the superannuation sector, in terms of both the number of entities and funds under management.<sup>82</sup> The value of assets held in SMSFs is expected to grow further.

### Preliminary assessment

#### Control, choice and competition

A number of submissions highlight the benefits of SMSFs to individuals and the superannuation system. SMSFs deliver members greater flexibility and control, because members can tailor their investments to suit their individual needs. Several stakeholders say this is often the main motivation of people participating in SMSFs.<sup>83</sup> Other drivers of the growth in SMSFs include perceived or actual lower fees and better tax outcomes. The growing number of SMSFs may be a positive sign that more Australians are actively engaging with their retirement savings.

Several submissions note that SMSFs provide a source of competition to APRA-regulated funds. Industry and retail funds have expanded their range of products in response to the growth in SMSFs and also provide administrative services to them. Some APRA-regulated funds are trying to match SMSF flexibility by providing more options that allow members to determine their investment allocation.

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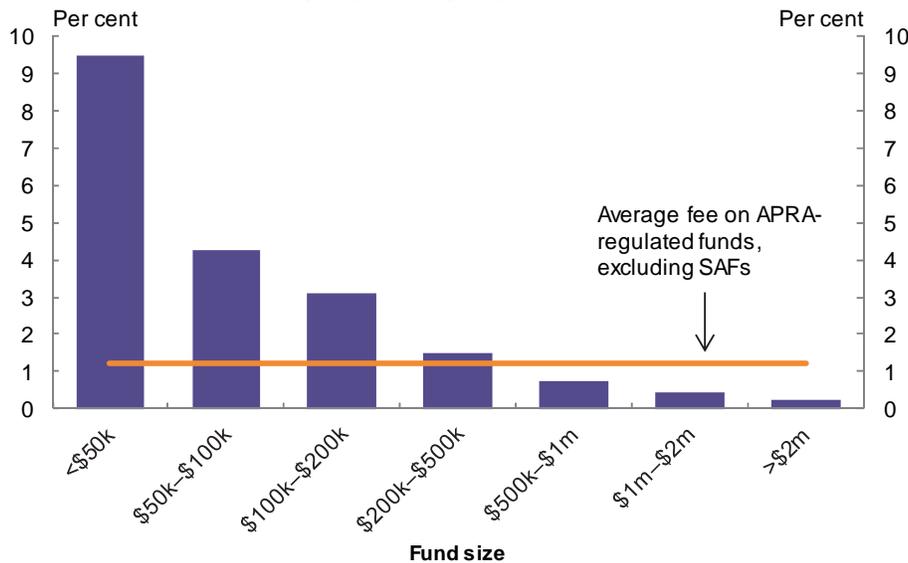
<sup>82</sup> Australian Prudential Regulation Authority (APRA) 2014, *Statistics: quarterly superannuation performance (interim edition)*, March ed, APRA, Sydney.

<sup>83</sup> Switzer Financial Group 2014, First round submission to the Financial System Inquiry, page 2; Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry, page 11.

### Cost effectiveness

Investment Trends data suggest that over than a third of SMSFs were set up to reduce the amount members pay in fees.<sup>84</sup> However, evidence on the effectiveness of this strategy is mixed. Rice Warner research suggests the average fee rate for SMSFs is lower than the industry average.<sup>85</sup> However, SMSFs with low balances are significantly more expensive to run. Several submissions highlight the negative correlation between the average operating expense ratio and the size of the fund (Chart 4.4).<sup>86</sup>

**Chart 4.4: SMSF average operating expense ratio, by fund size (2012)**



Source: ATO<sup>87</sup>, Rice Warner.<sup>88</sup>

84 Investment Trends 2014, *SMSF Investor Report*, April. Note: Based on a survey of 2,163 SMSF trustees.

85 Rice Warner 2014, *FSC Superannuation Fees Report 2013*, commissioned by the Financial Services Council.

86 SMSF Owners Alliance 2014, First round submission to the Financial System Inquiry; Industry Super Australia 2014, First round submission to the Financial System Inquiry; Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry.

87 Australian Taxation Office (ATO) 2013, *Self-Managed Super Funds: A statistical overview 2011–2012*, Table 22, ATO, Canberra. Care must be taken when using the operating expense ratio figures because comparisons between SMSFs and APRA-regulated funds may not be meaningful. While the methodology used to estimate the operating expense ratio is as close as possible to the method used by APRA, the data collected are not the same.

88 Rice Warner 2014, data provided to the Financial System Inquiry, 24 June 2014.

Estimates suggest that a SMSF requires a balance between \$200,000 and \$500,000, depending on how much work trustees outsource, to achieve equivalent costs to APRA-regulated funds.<sup>89</sup> Yet, in 2011–12, almost one-quarter of SMSFs had a balance of \$200,000 or less.<sup>90</sup> Even after being established for three years, 50 per cent of SMSFs had balances under \$330,000.<sup>91</sup>

### Benefits of scale

It is more difficult to diversify the asset allocation of a low-balance SMSF, both within and between asset classes, although new financial products are increasingly making this easier. Less diversification can result in SMSF members being subject to higher levels of risk in their portfolio. In addition, low balances may contribute to funds holding a higher proportion of cash due to minimum investment thresholds, which is likely to reduce returns. Exchange-traded funds provide a cost-effective vehicle for SMSFs to access the benefits of pooled and diversified investments.

When they purchase insurance policies, SMSFs are generally unable to realise the same cost economies as larger funds. Life, disability and income protection insurance may therefore be more expensive for individual SMSFs compared to other superannuation funds.

### Financial advice

Marketing and financial advice are encouraging individuals to establish SMSFs. According to Investment Trends, major reasons for establishing an SMSF include accountants' advice (30 per cent of respondents) and financial planners' advice (20 per cent of respondents).<sup>92</sup>

However, the quality of advice varies. ASIC's 2013 review of SMSF advice, as discussed in the *Leverage* section, found that around 1 per cent of advice provided was

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89 Research by Rice Warner found SMSFs with balances of \$200,000 and above can provide the same value as retail or industry funds, provided the trustees do some of the administration. Where balances are \$500,000 and above, SMSFs are competitive with industry and retail funds on a full-service basis and may be the cheapest option. Rice Warner 2013, *Costs of operating SMSFs*, commissioned by ASIC.

90 Australian Taxation Office (ATO) 2014, *Self-Managed Super Fund Statistical Report – March 2014*, ATO, viewed 25 June 2014, <[https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Quarterly-reports/Self-managed-super-fund-statistical-report---March-2014/?page=2#Total\\_asset\\_range\\_table](https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Quarterly-reports/Self-managed-super-fund-statistical-report---March-2014/?page=2#Total_asset_range_table)>.

91 Australian Taxation Office 2014, data provided to Financial System Inquiry, 6 June 2014. This is evident in each of the last three years of data; that is, for SMSFs established in 2007–08, 2008–09 and 2009–10.

92 Investment Trends 2014, *SMSF Investor Report*, April. Note: Based on a survey of 2,163 SMSF trustees.

considered ‘good’ and around 28 per cent was rated as ‘poor’.<sup>93</sup> Concerns about the quality of financial advice are discussed further in the *Consumer outcomes* chapter, including policy options to raise standards in the financial advice industry. The SMSF Professionals’ Association of Australia notes:

*We believe that there could be some improvements to the current financial advice environment to protect consumers and promote high quality, independent financial advice.*<sup>94</sup>

### Tax

A number of submissions highlight tax as a driver of the growth in the number of SMSFs. According to Investment Trends, 27 per cent of SMSFs were established because they were “more tax effective”.<sup>95</sup> Several submissions argue that SMSFs have tax advantages that APRA-regulated funds do not have. Currently, the tax treatment of all superannuation funds is the same, although in practice SMSFs may achieve better tax outcomes. This is due to more SMSFs being in the retirement phase and to the ability of SMSF trustees to tailor the choice and timing of investment decisions to their individual circumstances.<sup>96, 97</sup>

The Tax White Paper could examine the tax outcomes of SMSFs and APRA-regulated funds and measures to ensure that setting up an SMSF is not motivated purely by tax outcomes.

#### *The Inquiry seeks further information on the following areas:*

- To what extent should the Inquiry be concerned about the high operating expenses of many SMSFs?
- Should there be any limitations on the establishment of SMSFs?

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93 Australian Securities and Investments Commission (ASIC) 2013, *Report 337 – SMSFs: Improving the quality of advice given to investors*, ASIC.

94 SMSF Professionals’ Association of Australia 2014, First round submission to the Financial System Inquiry, page 25.

95 Investment Trends 2014, *SMSF Investor Report*, April. Note: Based on a survey of 2,163 SMSF trustees.

96 Australian Prudential Regulation Authority (APRA) 2014, *Statistics: Annual Superannuation Bulletin, June 2013 (revised 5 February 2014)*, APRA, Sydney.

97 Australian Taxation Office (ATO) 2013, *Self-managed superannuation funds: A statistical overview 2011-12*, ATO, viewed 25 June 2014, <<https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2011-2012/>>.

## Post-GFC Regulatory Response

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The GFC tested both the resilience of the Australian financial system generally and the performance of its regulators. We can learn many lessons from the GFC. This has been reflected in the substantial volume of regulatory change over recent years in Australia and internationally.

The Inquiry considers this an opportune time to revisit Australia's approach to stability and the prudential framework, consumer and conduct regulation, and our regulatory architecture, and in light of the GFC experience, to consider the need for any change.

<b>5: Stability</b>	<b>3-3</b>
<b>6: Consumer outcomes</b>	<b>3-49</b>
<b>7: Regulatory architecture</b>	<b>3-89</b>



## 5: Stability

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Maintaining stability in the financial system requires prudent management by financial institutions, sound macroeconomic policy, and a strong regulatory and supervisory framework. The Government should minimise the expectation of taxpayer funds being used to support the financial system. Nonetheless, given the Government may intervene during a financial crisis to avoid disorderly failures, a strong Government balance sheet is important.

The Global Financial Crisis (GFC) provided many lessons about the global financial system. This included: complexity and interconnectedness was greater than appreciated; many global financial institutions had too little capital to withstand a large shock; moral hazard was prevalent; liquidity can disappear in a crisis; and there was a lack of focus on system-wide risks. In response, governments and regulators implemented, or will implement, a number of international and domestic policy reforms.

The Inquiry has made the following observations about stability in the Australian financial system:

- During the GFC, significant government actions in a number of countries, including Australia, entrenched perceptions that some institutions are too-big-to-fail. These perceptions can be reduced in Australia by making it more credible to resolve these institutions without Government support.
- A number of jurisdictions have implemented new macroprudential toolkits to assist with managing systemic risks. The effectiveness of these for a country like Australia is not yet well established, and there are significant practical difficulties in using such tools.
- Australia has implemented some aspects of global prudential frameworks earlier than a number of jurisdictions. It has also used national discretion in defining capital ratios. When combined with other aspects of the prudential framework and calculated on a consistent basis, Australian banks' capital ratios (common equity tier 1) are around the middle of the range relative to other countries. However, differences such as those in definitions of capital do limit international comparability.
- To contribute to the effectiveness of the financial system, sound corporate governance requires clarity of the responsibilities and authority of boards and management. There are differences in the duties and requirements of governing bodies for different types of financial institutions and, within institutions, substantial regulator focus on boards has confused the delineation between the role of the board and that of management.

## Context

Australia has had a relatively stable financial system for most of the past two decades, following considerable disruption at the end of the 1980s and in the early 1990s. Other than the failure of several non-systemic financial service providers, the only major failure since the early 1990s was HIH insurance in 2001.<sup>1,2</sup> This period of stability is the result of a number of factors, including: a stable macroeconomic environment; a strong regulatory and supervisory framework; prudent risk management by financial institutions themselves; and a traditional, comparatively low-risk commercial banking model that remained profitable.

Financial instability limits the financial system's ability to allocate funds, facilitate payments, transfer risk and create liquidity. Instability can result in losses for users of the financial system and damage to the financial sector's ability to serve the economy. As shown by the GFC, it can also have severe negative effects on the economy, including low growth and high unemployment, and result in responses that lead to higher government debt. Financial instability can manifest in a number of ways. Most damaging is when several financial institutions fail at once or when a systemically important institution fails. Instability can also lead to large swings in asset prices, markets seizing up, and rapid changes in investor and depositor confidence.

Instability can come from many sources. Regulation is most focused on the parts of the financial system where the consequences of an institution failing are generally highest – such as banking and insurance – although risks can also arise from outside this regulatory perimeter.

## Balancing stability and efficiency

A systemic crisis can impose significant costs on the financial system and the broader economy. Globally, a Basel Committee on Banking Supervision (BCBS) literature survey puts estimates of the median cumulative global output cost of a financial crisis over a number of years at around 19 per cent of pre-crisis GDP, if growth returns to

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- 1 In other instances, weaker institutions were acquired by stronger institutions, avoiding potential failure.
  - 2 A number of non-prudentially regulated financial service providers have failed, including during the GFC. In some cases these involved significant losses for individual investors but did not destabilise the financial system or discernably damage the economy.

trend, or up to 158 per cent of pre-crisis GDP if the crisis has a permanent effect.<sup>3</sup> Haldane suggests the cumulative cost could be at least 90 per cent of 2009 world GDP.<sup>4</sup>

Within a country, the costs of instability are felt in their effect on the financial system, broader economy and in any taxpayer support required to minimise further damage. Academic studies suggest that the average cost of a banking crisis results in real GDP per person falling by 9 per cent and unemployment increasing by 7 percentage points.<sup>5</sup> During the crisis, United Kingdom taxpayer exposure to the financial sector peaked at £1.2 trillion (75 per cent of United Kingdom GDP),<sup>6</sup> while in Ireland financial sector support increased gross public debt by 40 per cent of GDP.<sup>7</sup> The Australian Government did not make a financial loss from its support to the financial system, but seasonally adjusted real GDP growth slowed from 4.8 per cent in the year to September 2007 to less than 1 per cent in the year to September 2009. The seasonally adjusted unemployment rate also increased from 4.0 per cent in August 2008 to 5.9 per cent by June 2009.

Stability can also come at a cost. Many measures to promote stability introduce barriers to entry to the financial system. These may reduce competition, place regulatory costs on financial institutions and reduce the availability of credit during economic upswings.<sup>8</sup> Policy makers need to be cognisant of this and balance any loss of efficiency or competition against the benefits of a stable system.

## Financial institutions

Different financial institutions pose different risks to stability.

The business of **banking** creates particular risks of failure. Banks are exposed to a wide range of risks through their core activities of credit intermediation and maturity transformation, including credit, liquidity, market and operational risks.

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3 Basel Committee on Banking Supervision (BCBS) 2010, *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, BCBS, Basel.

4 Haldane, A 2010, *The \$100 billion dollar question*, speech at the Institution of Regulation & Risk North Asia (IRRNA), 30 March 2010, Hong Kong.

5 Reinhart, C and Rogoff, K 2009, *This Time it is Different: Eight Centuries of Financial Folly*, Princeton Press, Princeton, NJ.

6 UK National Audit Office, Taxpayer support for UK banks FAQ, viewed on 18 July 2014 <<http://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/>>.

7 IMF 2013, *IMF Fiscal Monitor*, April 2013.

8 See for example Bank for International Settlements (BIS) 2011, *Basel III: Long-term impact on economic performance and fluctuations*, BIS Working Papers No. 338, BIS, Basel and Lowe, P 2012, *Bank Regulation and the Future of Banking*, remarks to the 41<sup>st</sup> Australian Conference of Economists, 11 July, Melbourne.

**Insurers** are less likely to generate or amplify systemic risk within the financial system or in the economy. This is because traditional insurance underwriting risks are less correlated with the economic business cycle and financial market risks. Although, in broad terms, financial market losses do not affect the magnitude of insurance liabilities, insurers do write business and conduct activities that are connected to the financial markets. Thus, the disorderly failure of a large insurer and the consequent cessation of coverage can damage the economy, as seen in the case of HIH.<sup>9</sup>

Since the Wallis Inquiry, **superannuation funds** have grown substantially in size and importance to the financial system. They are subject to market risk and so are susceptible to the failure of other financial institutions. However, their current limited direct leverage restricts superannuation funds' tendency to transmit or amplify financial shocks.

**Financial market infrastructure** (FMI), including trading platforms, high-value payment systems, clearing and settlement systems, and trade repositories, is the 'plumbing' of the financial system. Failure of these institutions could in some instances severely compromise the entire financial system's operation and be particularly costly.

The **shadow banking sector** includes many of the non-prudentially regulated financial institutions, such as mortgage finance companies, securities lenders, structured investment vehicles and hedge funds. The sector is a source of financial innovation but can also develop systemic risks. In part, this is because 'regulatory arbitrage' can see risky activity move from the regulated sector into the shadow banking sector. It can be difficult to identify risks in the shadow banking sector, as there is often a lack of transparency and relevant data.

## Regulatory framework

### Domestic

Australia's financial stability relies on its prudential framework. This framework seeks to avoid financial crises and minimise the incidence and cost of financial institution failures, while not unduly limiting competition or impeding innovation. A number of agencies have mandates to promote financial stability in conjunction with the Government, with the Australian Prudential Regulatory Authority (APRA), the Reserve Bank of Australia (RBA) and the Australian Securities and Investment

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<sup>9</sup> AIG in the United States is an example of a large insurance group failure that had systemic implications. The failure was primarily caused by losses in the group's non-insurance business.

Commission (ASIC) most prominent. For an overview of the regulatory structure, see the *Regulatory architecture* chapter.

The **RBA** has an implied mandate for the stability of the entire financial system. In this capacity, it provides ongoing monitoring and analysis of the system, using its public communications to highlight emerging risks. It is the provider of system liquidity and, in a crisis, can act as a lender of last resort.

**APRA** has responsibility for prudential supervision and financial stability. APRA regulates and supervises banks, building societies and credit unions, insurance companies and most segments of the superannuation industry. In terms of financial stability, its mandate is to set requirements for and supervise these institutions to reduce the likelihood they will fail. If an institution becomes financially distressed, APRA has primary responsibility for ensuring its return to health or managing its orderly failure.

**ASIC** does not have a formal mandate for ensuring financial stability. However, it provides oversight of a broad range of financial entities that fall outside the prudential perimeter. It can assist with identifying emerging systemic risks, for example in the shadow banking sector.

## International

The GFC was followed by a considerable international policy response. Financial supervisors around the world sought to coordinate their actions and achieve broad consistency across jurisdictions. This process is ongoing, with further change likely over the next few years.

Since 1988, the BCBS – of which Australia is a member – has set global standards to promote banking sector stability. All major economies follow the Basel framework, leading to a relatively consistent global approach to bank regulation, despite some differences in implementation.

Basel III, which was developed in the wake of the GFC, seeks to significantly increase the robustness of banks globally. Australia is adopting some aspects of Basel III earlier than a number of other jurisdictions and, although adhering to the minimum ‘headline’ capital ratios, has been more conservative in some details of its implementation.

The post-GFC era has also seen greater international coordination on policies regarding insurers and FMI. This work has generally been overseen by the Financial Stability Board (FSB) at the request of the G20, with the International Association of Insurance Supervisors (IAIS) developing insurance capital standards and the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) FMI standards.

## Too-big-to-fail<sup>10</sup> and moral hazard

Global history records governments of all political persuasions using taxpayer funds to support distressed institutions. As undesirable as it may be to put taxpayer funds at risk to support financial institutions, in the midst of a crisis it is often the fastest and most certain option to stabilise the system and avoid widespread economic damage.

Investors can rationally surmise that the government is likely to rescue systemically important institutions if no other options exist, as their collapse would cause the most damage to the financial system and broader economy. This leads to a belief that some institutions are too-big-to-fail — that they receive an implicit government guarantee.

Perceptions of this implicit guarantee have costs. A government may need to rescue a troubled institution in a crisis, putting taxpayer funds at risk. It may also cause ‘moral hazard’. This means it may encourage systemically important institutions to take on more risk than is optimal, since they believe they receive any benefits from the risk taking while the government will bear the cost of failure. Further, investors may believe they will not make a loss, even if the institution fails, so they have less incentive to monitor the institution’s risks and apply market discipline. This can lead to a lower cost of funding for these institutions.<sup>11</sup> Any lower funding costs might allow the institutions to become larger and more systemically important. The overall system can therefore become larger than is economically efficient, exacerbating the size of the potential cost of a crisis and therefore the size of the perceived guarantee.

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10 Too-big-to-fail is a term often used in international policy discussions to refer to systemically important financial institutions that, were they to fail, would cause significant economic and financial damage. An institution may be systemically important because it is large, but also because of its complexity, market importance, interconnectedness or a lack of substitutes for critical service it provides.

11 See for example Tarullo, D 2009, *Confronting Too Big to Fail*, speech at the Exchequer Club, October 21, Washington DC.

## Preliminary assessment

### *Observation*

During the GFC, significant government actions in a number of countries, including Australia, entrenched perceptions that some institutions are too-big-to-fail. These perceptions can be reduced in Australia by making it more credible to resolve these institutions without Government support.

During the GFC, a number of countries provided financial support to struggling financial institutions, including capital injections and debt guarantees.<sup>12</sup> The goal was to avoid wider systemic impacts if these institutions were to fail, as happened in the case of Lehman Brothers. However, in doing so these governments entrenched a belief that some institutions were too-big-to-fail. The challenge since the crisis has been to alter these beliefs.

Government can take measures to make it more likely, or more credible, to be able to impose losses on creditors, avoiding future Government interventions and lowering the cost or probability of a large institution failing. No single measure is a complete solution, but each strengthens the likelihood or credibility of orderly resolution with minimal taxpayer support, which in turn reduces the contingent liability to the Government and perceptions of an implicit guarantee.

## Policy options for consultation

It is hard to completely eliminate perceptions that some institutions are too-big-to-fail, as there will always be pressure on governments to prevent the disorderly failure of a financial institution. However, the Government can take measures to minimise the extent of these perceptions through making an orderly resolution more likely with minimal need for Government support, and reducing the probability that such institutions will fail.

Globally, the GFC revealed: complexity and interconnectedness was greater than appreciated; many global financial institutions had too little capital to withstand a large shock; moral hazard was prevalent; liquidity can disappear in a crisis; and there was a lack of focus on system-wide risks. International forums, particularly the G20, have taken these lessons and sought international policy responses to reduce the potential for taxpayer funds being put at risk from government support for

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<sup>12</sup> Financial Stability Board (FSB) 2010, *Reducing the moral hazard posed by systemically important financial institutions*, interim report to G20 Leaders, FSB, Basel.

systemically important financial institutions (SIFIs). Among other things, this has resulted in strengthened international frameworks for capital, liquidity, financial market infrastructure and resolution.

Australia has been part of this international process, including through its 2014 Presidency of the G20, and has adopted many of the measures. However, other countries have pursued a range of additional steps – or gone further than Australia – to reduce the potential costs posed by systemically important institutions. These additional measures are worth examining in the Australian context:<sup>13</sup>

- Further strengthening recovery and resolution frameworks
- Further enhancing regulatory requirements for systemic financial institutions, including higher capital requirements and stronger risk management and stress testing requirements
- Mandating structural changes for individual banks, or imposing general ring-fencing requirements or banning certain activities considered to be high risk

The options discussed aim to reduce the costs associated with too-big-to-fail institutions. They aim to make the financial system safer and reduce the likelihood of taxpayer funds being used to support a financial institution. Many of these measures could also have an effect on competition.

Some of these options would be relatively straightforward to implement with minimal cost. However, others are much more difficult to adopt and would require significant change to the Australian financial system.

### Recovery and resolution preparedness

It is not possible to eliminate failure from the financial sector. It is not even desirable; the ability of good institutions to prosper and inefficient ones to fail is a key feature of competition. However, liquidating financial institutions is a complex and slow process, which can weaken confidence and lead to contagion in the broader financial system. Financial institutions need a strong, effective and credible recovery and resolution regime to help ensure any failure is orderly and has a minimal cost to the financial system, the broader economy and the Government.

Many recovery and resolution options have little or no compliance cost for industry; for example, powers are only relied upon where an institution is facing acute financial

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<sup>13</sup> APRA's submission raises ways in which its crisis management powers could be enhanced, while the RBA submission discusses macroprudential policy, structural banking reforms and powers relating to financial market infrastructure.

distress. In normal times, the regulatory burden of these options can therefore be negligible or non-existent. However, some options, such as requirements for industry to structurally preposition, do impose costs.

### *Imposing losses on creditors*

When a business fails, it would ordinarily enter corporate insolvency or administration procedures to be sold or liquidated, with any value returned to creditors. Generally, the value of the assets will not be enough to repay all creditors the whole amount owing, and some will take a loss. Achieving this in a manner that meets financial stability objectives is more difficult in the context of a financial institution. Critical services provided by the institution may need to be continued or wound down in an orderly manner outside normal insolvency processes. In addition, creditors are often other financial institutions – imposing losses on these institutions, especially in the middle of a financial crisis, can worsen the situation. Disorderly resolution of one institution can create instability through a loss of confidence and changes in investor risk appetite. In many past instances, both in Australia and elsewhere, this has led governments to intervene to restore stability.

Introducing credible ways to impose losses on creditors in the event of failure assists in achieving orderly resolution with minimal use of taxpayer funds. This goes some way to addressing perceptions that some institutions have an implicit guarantee by reducing expectations of Government support, and encouraging investors to pay greater attention to risk. This is evident in Moody's decision to place Canadian banks on a negative outlook, which was "taken in the context of previously announced plans by the Canadian government to implement a 'bail-in' regime", which "may reduce [Moody's] systemic support assumptions".<sup>14</sup>

There are complexities involved in making it more credible to impose losses on the creditors of financial institutions. These include: questions around the nature of the liabilities that may best be able to absorb losses in resolution; ensuring that relevant creditors are capable of bearing loss without systemic contagion; appropriate mechanisms and triggers for imposing losses on creditors; interaction with the existing regulatory capital framework;<sup>15</sup> and the effect on funding costs in normal times.

The G20 continues to consider elements of these issues, in particular through its work on the adequacy of global systemically important institutions' loss absorbing capacity when they fail (gone concern loss absorbing capacity, or GLAC). There is value in an internationally consistent approach to promote a level playing field globally. The

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<sup>14</sup> Moody's 2014, *Rating Action: Moody's changes outlook to negative on Canadian banks' supported ratings*, Moody's Corporation, New York.

<sup>15</sup> For example, some Australian banks have already issued securities with 'bail-in' clauses that qualify as Tier 2 capital for meeting minimum capital requirements.

proposals include government and regulator discretion to impose losses on particular classes of creditors, and mandating issuance of financial instruments that resolution authorities can confidently expose to loss or convert to equity in resolution, while minimising financial instability and risks to other public interest objectives. The proposals seek to ensure resources are available to provide solvency to a systemic institution via a bridge or a bail-in transaction sufficient to sustain its critical services until the institution can be subjected to an orderly wind-down or solvent restructuring. Although these proposals are being developed for globally systemically important banks, it is possible that they will have implications for Australian institutions.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Increase the ability to impose losses on creditors of a financial institution in the event of its failure.

*The Inquiry seeks further information on the following area:*

Is it possible to reduce the perceptions of an implicit guarantee for systemic financial institutions by imposing losses on particular classes of creditors during a crisis, without causing greater systemic disruption? If so, what types of creditors are most likely to be able to bear losses?

### *Financial market infrastructure oversight and resolution*

FMI includes trading platforms, high-value payment systems, clearing and settlement systems, and trade repositories. Such facilities are critical in a modern financial system, as they match buyers and sellers and facilitate the transfer of both funds and title to assets, and thus trading of goods, services and financial assets. If these facilities fail, it can cause severe systemic disruption.

FMI is regulated and supervised by the RBA and ASIC. Broadly, the RBA is responsible for ensuring the stability and safety of FMIs, while ASIC is responsible for their fair and effective provision of services.

The Council of Financial Regulators (CFR) has identified a number of gaps in the regulatory framework for FMIs, particularly related to resolution.<sup>16</sup> These include: a

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<sup>16</sup> Stevens, G 2012, 'Review of Financial Market Infrastructure Regulation', Letter to The Hon. Wayne Swan, MP, Deputy Prime Minister and Treasurer, 10 February.

lack of appropriate direction powers; the ability to step in to control an FMI, if appropriate; the ability to mandate the location of services; and lack of fit and proper standards for FMI directors and officers. A large focus of these proposed changes is ensuring that, if an FMI fails, regulators are able to step in to keep its critical services operating.

The Inquiry understands that CFR agencies have developed a set of legislative proposals for future Government consideration to address the gaps identified, and supports this process.

### *Resolution powers*

International Monetary Fund (IMF) and FSB analysis concluded that Australia's resolution regime for banks and insurers was broadly consistent with international best practice.<sup>17</sup> However, a comparison with the FSB's Key Attributes of Effective Resolution revealed several gaps in resolution tools and powers.

The gaps identified include: powers to address a distressed foreign bank branch in Australia; the ability to require restructuring of a regulated entity to facilitate resolution; deficiencies in powers to resolve group distress; a lack of statutory 'bail-in' powers to impose losses on particular creditors; no resolution or privately funded protection funds; and no formal mechanism for recovery of taxpayer funds. Options identified by the IMF to address these gaps included giving regulators additional directions powers and the ability to levy the industry for any non-financial claims scheme (FCS)-related resolution expenditure by the authorities.

The previous Government consulted on measures to address most of the gaps, with little industry concern except on a small number of specific proposals. The Inquiry supports this continuing process.<sup>18</sup> Although many of the gaps identified for change were relatively minor in isolation, their cumulative closing would enhance APRA's crisis management powers and more closely align Australia with international standards and best practice.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements
- Strengthen regulators' resolution powers for financial institutions.

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<sup>17</sup> International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF Country Report No. 12/308, IMF, Washington DC.

<sup>18</sup> Australian Treasury 2012, *Strengthening APRA's Crisis Management Powers*, consultation paper, Treasury, Canberra.

### *Pre-planning and pre-positioning*

Strong resolution powers are not enough. Regulators and Government need to be willing and prepared to use them. Many crisis management options are only credible with significant pre-planning. In a crisis, the more options available, the more likely a credible, low-cost option to prevent a disorderly collapse can be found that does not involve putting taxpayer funds at risk. Pre-planning can also increase the consistency of Government approaches to crises and, through public communication, can increase the predictability and transparency of Government responses.

Australia could do more to be in a position to use resolution powers effectively. This could involve pre-planning for failure, both generically and by developing plans for specific institutions, and testing these plans through crisis simulations.<sup>19</sup> The regulators can oversee that institutions build credible sources of loss absorbency in resolution and, at the same time, Government can ensure its balance sheet remains strong.

Pre-planning is not without cost. It can be resource intensive for regulators. It can also impose a burden on the industry, which may have to devote resources to develop internal recovery plans, provide data to regulators and make business changes to address any identified barriers to resolution. However, compared to other options, additional pre-planning is likely to be relatively low cost.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Invest more in pre-planning and pre-positioning for financial failure.

### Capital requirements

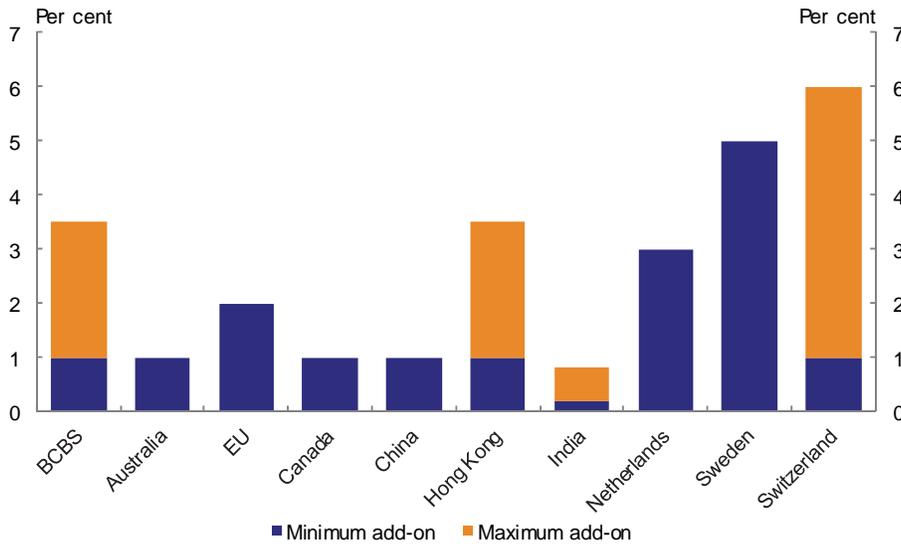
In December 2013, APRA identified the four major banks as domestic systemically important institutions and increased their capital requirements, from 2016, by

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<sup>19</sup> Under the current framework, the CFR runs crisis simulation exercises every two years, with other crisis management training events held every alternate year. Individual agencies also run internal crisis simulations.

1 percentage point.<sup>20</sup> Increased capital requirements for systemically important banks are in line with international practice. Most jurisdictions adopting the Basel framework have introduced, or will introduce, similar measures. Australia’s requirement is at the low end of the international spectrum, which ranges from 1 percentage point to around 6 percentage points for the largest banks in Switzerland (Chart 5.1). In their submission, the regional banks suggested that a higher capital add-on for systemically important banks could be warranted.

**Chart 5.1: Capital ratio add-ons for systemically important banks<sup>(a), (b)</sup>**



(a) Includes capital add-ons for both Global Systemically Important Banks (G-SIBs) and Domestic Systemically Important Banks (D-SIBs). For the European Union this is for ‘other systemically important institutions’.

(b) Where countries have a range of possible capital add-ons, ‘minimum’ and ‘maximum’ show the floor and ceiling of that range. Where countries have the same capital add-on for all systemically important banks, this is shown as its ‘minimum’.

Sources: APRA, BCBS, China Banking Regulatory Commission, De Nederlandsche Bank, Swiss Financial Market Supervisory Authority (FINMA), Hong Kong Monetary Authority, Japan Financial Services Agency, Monetary Authority of Singapore, Office of the Superintendent of Financial Institutions Canada, Reserve Bank of India, Sveriges Riksbank.

Increasing capital requirements reduces the likelihood of institutional failure. It gives a greater capital buffer to systemically important banks, whose collapse would cause significant damage to financial markets and the economy. Higher capital also helps ameliorate the effects generated by perceptions of an implicit guarantee.

Some stakeholders have argued Australian banks already have adequate levels of capital. ADIs have increased capital levels since the GFC and have arguably reduced

<sup>20</sup> Australian Prudential Regulation Authority (APRA) 2013, *Domestic Systemically Important Banks in Australia*, APRA Information Paper, APRA, Sydney.

the risk in their asset portfolios.<sup>21</sup> In addition, equity funding is typically thought to be more expensive than debt funding, although a greater use of equity funding reduces bank failure risk and therefore may lower investors' required return on equity and the cost of borrowing.<sup>22</sup>

The Inquiry notes that the FSB's framework for global systemically important institutions includes insurers as well as banks. The IAIS is currently finalising the methodology for identifying global systemically important insurers, although this is unlikely to include any Australian institutions. It is not yet clear what arrangements, if any, will be made for domestic systemically important insurers.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Further increase capital requirements on financial institutions considered to be systemically important domestically.

## The Financial Claims Scheme

The FCS was introduced as part of the Government's response to the GFC. It provides a government guarantee of retail deposits held at Authorised Deposit-taking Institutions (ADIs) up to the value of \$250,000 per account holder per ADI. The scheme fully covers around 99 per cent of eligible depositors and over half of deposits by value.<sup>23</sup> The deposit guarantee aims to give depositors confidence in the safety of their money during a crisis, preventing panic and bank runs that may exacerbate the crisis. A similar scheme is in place for general insurance policy holders should an insurer fail.

Like all government guarantees, the FCS could create moral hazard for depositors by removing credit risk.<sup>24</sup> The depositor can place funds with any ADI without regard to the riskiness of the institution. In the context of reducing the adverse effects of too-big-to-fail, the FCS assists smaller institutions; absent such a guarantee, depositors

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21 Coffey, P 2014, *Financial System Inquiry: Funding Australia's Economic Future*, presentation to the Committee for Economic Development of Australia, 13 June, Sydney

22 Admati, A and Helwig, M 2013, *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*, Princeton Press, Princeton NJ.

23 International Monetary Fund (IMF) 2012, *Australia: Financial Safety Net and Crisis Management Framework – Technical Note*, IMF Country Report No. 12/310, IMF, Washington DC.

24 It should be noted that, unlike other guarantees, the FCS may not materially affect the market discipline of deposit-taking institutions in normal times. This is because retail depositors are typically not able to adequately assess the relative riskiness of banks due to the information asymmetries.

could be expected to move their funds to the larger institutions if they perceive these to be the safest.

Some submissions criticise the form of the FCS, noting that pre-positioning for implementation is complicated and has been expensive. In particular, the ‘single customer view’ required per individual, per ADI has practical difficulties. In addition, complexity may make it challenging to distribute funds to affected depositors in a timely manner. This may undermine the scheme’s effectiveness in a crisis; it is important to meet depositors’ expectations of fast and accurate payouts, both to ensure system stability and to avoid losses for individuals. It should be noted that the increased confidence from the presence of the FCS may assist in preventing a crisis from occurring.

The FCS threshold of \$250,000 is high by comparison to most deposit insurance schemes internationally,<sup>25</sup> and some submissions argue it is too high.<sup>26</sup> This threshold should be high enough to cover the average depositor’s funds to avoid people withdrawing funds during a crisis. However, the higher the threshold, the greater the allocative efficiency distortion it can cause, giving greater incentive for individuals to invest in deposits compared to other assets.<sup>27</sup>

Currently, the FCS is post-funded. This means that, if it were activated, the Government would initially pay out claims and then recover those funds from the assets of the failing institution. If that was not sufficient, the remainder would be recovered through a levy on the rest of the banking sector, which could be delayed until the crisis was over to avoid exacerbating the situation.

An option is to charge ADIs an ex ante fee, or pre-funding, for the FCS; the IMF recommended that Australia “Re-evaluate the merits of ex ante funding for the FCS”.<sup>28</sup> Ultimately this fee would likely be passed on to depositors, which would satisfy a ‘user pays’ principle for the deposit insurance provided. In addition, depending on how it was structured, an ex ante fee could collect a dedicated pool of funds that could be rapidly accessed to meet FCS claim needs. Broadening the allowable use of these funds to include measures that reduce the magnitude of FCS claims – such as assisting in resolution – may reduce the overall burden of the scheme.

However, an ex ante model would impose a cost on the financial sector. In particular, industry would need to pay a fee that would likely be passed on, at least in part, to

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25 Financial Stability Board (FSB) 2012, *Thematic Review on Deposit Insurance Systems*, peer review report, 8 February, FSB, Basel.

26 For example, Challenger 2014, First round submission to the Financial System Inquiry, Attachment 15.

27 The *Funding* chapter discusses tax factors that make deposits less attractive to households.

28 International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF Country Report No. 12/308, IMF, Washington DC, November.

depositors in the form of lower deposit interest rates or higher fees. This would be the case even if there was no need to activate the FCS. By contrast, the current ex post funding only imposes a cost on industry if the guarantee is needed.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Modify the FCS, possibly including simplification, lowering the insured threshold or introducing an ex ante fee.

*The Inquiry seeks further information on the following areas:*

- What measures could be taken to simplify the FCS with minimal burden on industry, while still ensuring the effectiveness of the scheme?
- What is an appropriate threshold for the FCS guarantee of deposits?

## Ring-fencing

Following the GFC, several major jurisdictions introduced or proposed significant structural reforms to their banking sectors through ring-fencing. The goal of ring-fencing is to ‘carve out’ specific financial activities to protect them from other activities that are less critical to economic activity — and are likely to be riskier. This might involve separating commercial banking from investment banking, or insulating domestic operations from risks in offshore activity. There is no one way to implement ring-fencing, with approaches differing by country (Box 5.1).

Such measures help address the costs of too-big-to-fail institutions in three ways:

1. Although all parts of a bank may collectively be too-big-to-fail, each individual part may not be. This is not a matter of size — the complexity of an institution also affects whether it is possible to resolve in an orderly fashion. A simpler internal bank structure, where core activities are already separate, would make resolution easier.
2. Although there may be a political and economic imperative to provide government support to core services, such as access to retail deposits, this is less likely to be the case for investment banking activities. Ring-fencing can allow Government greater ability to limit support to only the core aspects of the business, reducing the associated perceived implicit guarantee.

3. By separating different types of activities, an institution's approach to risk appetite, including remuneration structures which affect risk taking, may become more appropriately aligned to those activities.

### *Ring-fencing in Australia*

Currently, the share of Australian banks' balance sheets used for investment banking activities, and the extent of proprietary trading, is lower than in many other jurisdictions.<sup>29</sup> Among other things, this could reflect a lack of retail competition that makes 'plain vanilla' banking profitable without the need to take on riskier business, or relative returns to investment banking in Australia being low.

Ring-fencing would come at a cost. Of the measures discussed in this section, it is likely to be the most burdensome. It involves costs to institutions of restructuring, ongoing efficiency costs through reduced diversification benefits, and may introduce barriers to foreign entrants and limit Australian banks' ability to expand internationally.

The United Kingdom Treasury estimates ring-fencing United Kingdom institutions will involve a transition cost of around £3 billion, with ongoing costs of around £420 million to £1.9 billion per annum (0.04 to 0.16 per cent of United Kingdom GDP). Efficiency can also be a casualty, as firms are forced into a corporate structure other than what they would choose if not constrained. However, the estimated net present benefit of the United Kingdom reforms is £114 billion through reduced probability and severity of future financial crises.<sup>30</sup>

Unlike in the United Kingdom, the mixture of retail and investment banking in Australia is more limited. This means the immediate costs and benefits of such a policy may also be more limited. That said, introducing ring-fencing now could assist in avoiding future issues if banks were to move more into riskier activities. For example, banks may move into riskier investment bank activities searching for higher returns, as increased competition or other factors make safer lending less profitable.

Although implementing ring-fencing now would be costly, it would be less costly than if it were introduced at a time when banks were engaged significantly in both ring-fenced and other activities.

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<sup>29</sup> IMF data show that in 2012 the share of bank income from trading activities was 4.6 per cent in Australia, 27.3 per cent in Germany, 15.3 per cent in the United Kingdom and 6.2 per cent in the United States. Australian Financial Markets Association (AFMA) and Australian Bankers' Association (ABA) 2012, *Joint ABA and AFMA response to the Fundamental Review of the Trading Book*, 7 September, also states that countries like Australia have "less complex trading books, compared to European or North American jurisdictions".

<sup>30</sup> HM Treasury 2013, Impact Assessment: Financial Services (Banking Reform) Bill, July 2013.

It is worth noting that Australia had a type of de facto ring-fencing before the 1990s, when the major banks each had separate trading bank and savings bank arms, but Government policy during deregulation removed that distinction.

The Inquiry seeks views on whether ring-fencing could be of net benefit to Australia and, if so, what model of ring-fencing would best suit our conditions. In particular: what types of activity should be ‘inside’ the fence and what should not; and how ‘high’ should the fence be — that is, how strongly should activities be separated?

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Ring-fence critical bank functions, such as retail activities.

*The Inquiry seeks further information on the following areas:*

- Is there a case for introducing ring-fencing in Australia now, or is there likely to be in the future?
- If ring-fencing is pursued, what elements should be protected and from what risks? For example, should deposit-taking functions be protected from proprietary trading. Is one of the models used overseas appropriate for Australia?
- How ‘high’ should any ring-fence be? Do ring-fenced activities need to occur in entirely separate financial institutions, or could they be part of a group structure that has other business activities? Within a group, what level of separation would be necessary?
- Are there ways to achieve the same benefits as ring-fencing without the costs of structural separation?

### **Box 5.1: International approaches to ring-fencing**

#### **United States – The ‘Volcker rule’**

The Volcker rule aims to reduce banks’ exposure to speculative investments that could put depositor funds at risk. It does this by prohibiting banks (including foreign banks) from engaging in proprietary trading. They cannot buy or sell assets for speculative reasons for the bank’s own purposes – only on behalf of a client – but they can still undertake hedging activity to manage their risks. The Volcker rule also prohibits banks from investing in hedge funds and private equity funds.

#### **United States – Glass-Steagall Act**

Operating prior to the GFC, for most of the 20<sup>th</sup> century the Glass-Steagall Act required that commercial banks and investment banks be separate entities. Its goal was to protect deposits in commercial banks from being exposed to the riskier activities conducted by investment banks. This provision of the Act was repealed in 1999.

#### **United Kingdom – Vickers**

Following the Independent Commission on Banking (the Vickers report), the United Kingdom is in the process of introducing ring-fencing of United Kingdom banks’ core activities, ensuring that core services can continue, even if the risky parts of the business get into difficulty. This requires core financial services, such as retail deposits and overdrafts, to be placed in a separate subsidiary within a holding company, ring-fenced from any securities trading and other risky activities. Ring-fenced subsidiaries must be separately capitalised, with each meeting the regulator’s capital and liquidity requirements, and should be legally, financially and operationally independent.

#### **European Union – Liikanen**

Current proposals in the European Union ban proprietary trading and, potentially, separate particular trading activities from deposit-taking entities. This draws on recommendations in the Report of the European Commission’s High-level Expert Group on Bank Structural Reform (the Liikanen report). Hedging, trading on behalf of clients and trading for cash management purposes would still be allowed. If the regulator required a function to be separate, the function would need to be legally and operationally distinct from the rest of the bank.

## Systemic risk

The GFC highlighted that focusing on the soundness of individual institutions, without stepping back to consider the overall financial system, is not sufficient to ensure financial stability. Externalities and spill-over effects can mean that, even where an individual institution's capital, risk exposure and liquidity look sound, systemic risks can be building up. Yellen described it as "akin to caring for an entire ecosystem rather than individual trees".<sup>31</sup>

The issue is that, if a regulatory system is primarily focused on institutions, it can be hard to both monitor and respond to systemic risk. This is particularly true when data on institutions outside the prudential regulatory perimeter is scarce. Australia's regulatory framework deals with this issue by being designed to enable a focus on the system as a whole, yet allowing for tools to be applied to individual institutions to achieve systemic goals.

## Preliminary assessment

### Monitoring

APRA, the RBA and ASIC have a well-established system for monitoring systemic risk in Australia.<sup>32</sup> APRA considers system-wide issues as part of its approach to supervising financial institutions. The RBA complements this with its own analysis of the financial system, with an eye to emerging systemic risks. The two agencies coordinate and share their analysis with each other and other agencies through the CFR, as well as through day-to-day contact between the agencies. The RBA's semi-annual Financial Stability Reviews make this analysis available to the broader public. ASIC's monitoring of FMI and non-prudentially regulated financial service providers contributes to identifying systemic risks outside the prudential perimeter.

APRA's mandate for pursuing financial system stability was codified in the 2006 amendment to the APRA Act, which required the regulator "to promote financial system stability in Australia". The RBA takes its mandate to promote financial stability as implied under the *Reserve Bank Act 1959*. Financial stability is also explicitly

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31 Yellen, J 2009, *Linkages between Monetary and Regulatory Policy: Lessons from the Crisis*, presentation to the Institute of Regulation & Risk, North Asia, November, Hong Kong.

32 International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF Country Report No. 12/308, IMF, Washington DC, November.

included in the Statement on the Conduct of Monetary Policy agreed between the Treasurer and the Governor of the RBA, most recently in October 2013.<sup>33</sup>

Significant reforms to improve the transparency of over-the-counter (OTC) derivatives since the GFC strengthen the monitoring of these instruments. Uncertainty about the derivatives exposures of institutions in the GFC negatively affected market confidence, increased perceptions of counterparty risk and made resolution of institutions with large derivatives books difficult. Reforms have included work to: standardise OTC derivative contracts; mandate that some OTC derivatives be traded on platforms and cleared through central counterparties; and record transactions on trade repositories.

As markets continue to develop, financial and technological innovations are emerging rapidly. These developments result in new products and services to enable consumers to manage and conduct their financial activities. Allowing activity outside regulatory perimeters encourages innovation and competition. However, new products can bring new risks. This was highlighted by the GFC, where the proliferation of new and complex asset-backed securities structures, such as collateralised debt obligations, contributed to risk transparency problems in the United States.

History tells us that the next financial crisis never looks quite like the last.<sup>34</sup> It is not possible to know for certain where systemic risks will arise; however, it is perhaps more likely that they will emerge outside the prudentially regulated part of the financial system, such as in the shadow banking sector, where oversight is more limited. It is therefore important that monitoring arrangements are adequate for identifying risks wherever they might develop. This will require regulators to have adequate access to data.<sup>35</sup>

Global regulators have expressed their concern about the increasing use of shadow banking and its potential to generate systemic risks.<sup>36</sup> The CFR recently considered developments in shadow banking in Australia, concluding that risks to stability remain limited. This is consistent with the size of the shadow banking sector as a share of financial sector assets declining substantially since the GFC (Chart 5.2). However, the CFR still recommended ongoing monitoring of emerging risks outside the perimeter.

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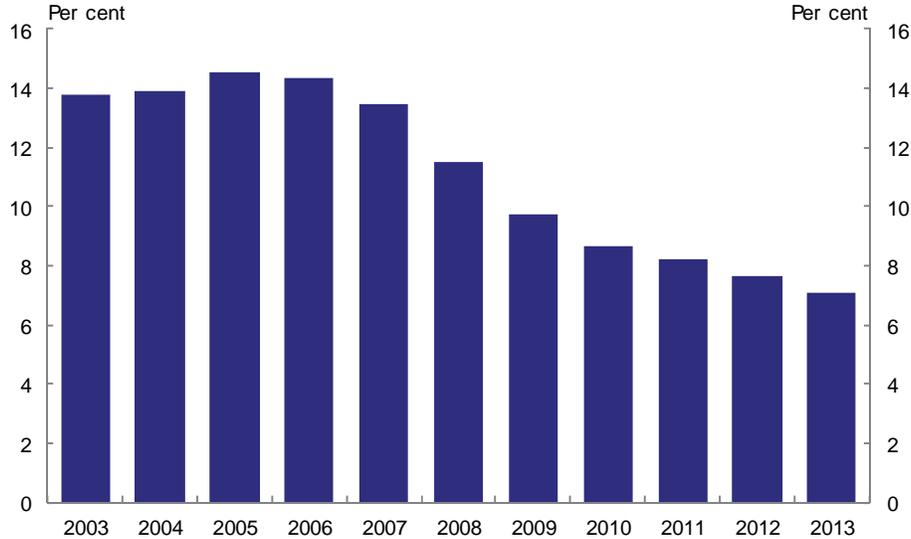
<sup>33</sup> RBA and Treasury 2013, *Statement on the Conduct of Monetary Policy*, 24 October 2013.

<sup>34</sup> Edey, M 2011, *Basel III and Beyond*, speech to Basel III Conference, 24 March, Sydney.

<sup>35</sup> See the *Regulatory architecture* chapter for discussion of regulator data access.

<sup>36</sup> The FSB has a workstream focused on the shadow banking sector – see Financial Stability Board (FSB) 2013, *Global Shadow Banking Monitoring Report 2013*, FSB, Basel.

**Chart 5.2: Shadow banking sector<sup>(a)</sup>**  
Share of financial system assets, end December



(a) Based on the FSB's definition of 'broad' and 'narrow' estimates of shadow banking. Estimate excludes assets that are part of prudentially-regulated banking groups and assets related to equity trusts and self-securitisation.

Sources: ABS, APRA, RBA.

Current tools to address systemic risks are mostly applicable within the prudential perimeter, as discussed in the next section. This could be problematic if such risks are identified in other parts of the financial system, since the most effective way to manage these risks may be to subject the relevant institutions or activities to heightened regulatory and supervisory intensity. This is a gap in the current arrangement.

## Macroprudential powers

### *Observation*

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

In conducting prudential policy, APRA has an eye to both the soundness of individual institutions and the financial system more broadly. APRA's existing prudential tools to deal with emerging systemic risks include supervising particular institutions or lines of business more intensively, and changing capital or other prudential requirements

for individual institutions. As part of the Basel III implementation, APRA can also activate a counter-cyclical capital buffer for the whole deposit-taking industry.

Communication is important as it can mould risk perceptions and affect risk-taking behaviour.<sup>37</sup> In normal times, the RBA primarily relies on its public communications – such as speeches and the semi-annual Financial Stability Review – to highlight its concerns about any build-ups in systemic risk and potentially shape the expectations and actions of other parties. The RBA also takes any such risks into consideration in formulating monetary policy. In addition, in a crisis, the RBA can supply the financial system with liquidity and is the lender of last resort.

Unlike some other jurisdictions, Australia has not explicitly introduced macroprudential tools in the wake of the GFC.<sup>38</sup> These tools are designed to address build-ups of systemic risk. They are typically applied in a counter-cyclical fashion at a system-wide level, rather than tailored to different institutions. Often, they take the form of limits on loan-to-value ratios (LVRs) in mortgage lending and maximum debt-servicing-to-income ratios.

Another example is the provision in Basel III to allow time-varying capital requirements for banks. This builds up capital in good times which can be run down during stress periods. This is similar to the dynamic provisioning used by countries such as Spain before the GFC, where banks build up larger provisions for impaired assets during good times, in recognition that regular provisioning under international accounting rules often does not reflect the actual experience in a downturn.

Some studies suggest that these tools can be of benefit in the right circumstances.<sup>39</sup> Their purpose is to manage systemic risks by, for example, curbing the excesses in asset price inflation, risk appetite or credit growth. In doing so, they aim to limit the incidence and severity of financial crises in the future. However, the RBA's submission notes that evidence on the effectiveness of such tools is still limited, especially on their application in advanced economies.

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37 Australian Prudential Regulation Authority (APRA) and Reserve Bank of Australia (RBA) 2012, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework*, APRA and RBA, Sydney.

38 Aside from the counter-cyclical capital buffer contained in Basel III.

39 Lim, C, Columba, F, Costa, A, Kongsamut, P, Otani, A, Saiyid, M, Wezel, T and X Wu 2011, *Macroprudential Policy: What Instruments and How to Use Them? Lessons from Country Experience*, IMF Working Paper WP/11/238, IMF, Washington DC.

There are practical difficulties to using macroprudential tools.<sup>40</sup>

- Deciding when to use macroprudential tools involves identifying unsustainable trends such as asset price or credit bubbles and build-ups of risk in the financial system. Although the problem is usually obvious in hindsight, identifying these trends ex ante has proven extremely difficult for regulators, central banks and investors globally.
- In many ways, the macroprudential tools being proposed and implemented today are not too different from the quantitative restrictions used in Australia prior to financial deregulation in the 1980s. That experience showed that such restrictions can have large negative effects on efficiency and cause financial activity to move to the unregulated part of the system; for example, the shadow banking sector.
- Many macroprudential tools are focused on the housing market, such as LVR caps, but will have little effect on other possible sources of systemic risk. Having the right tools to address all potential sources of risk would require granting a substantial degree of power to the responsible regulator.
- Whereas monetary policy is relatively transparent and predictable, with a clearly articulated target, the targets of macroprudential policy are more numerous and less clearly defined. This makes it harder for the public to predict the use of these tools, adding additional uncertainty to the financial system. It may also send conflicting policy signals; for example, if monetary policy is being loosened while maximum LVR ratios are being lowered.

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<sup>40</sup> RBA 2014, First round submission to the Financial System Inquiry, contains a fuller discussion of some of the difficulties with operationalising these kinds of macroprudential tools.

### Box 5.2: Macroprudential tools in other countries

Approaches to using macroprudential powers vary significantly among countries. In some instances they are used by countries as a substitute for independent monetary policy – often the result of a managed exchange rate regime.

Approaches include:

- Authorities in Singapore have focused on measures to limit house price inflation. These include mortgage LVR caps, mortgage tenure restrictions, increased property stamp duty and increased land allocated to residential development.<sup>41</sup>
- The Reserve Bank of New Zealand (RBNZ) has identified four macroprudential tools that it may use: the (Basel III) counter-cyclical capital buffer; adjustments to the minimum core funding ratio; sectoral capital requirements; and restrictions on high-LVR residential mortgage lending.<sup>42</sup> Concerned that the housing markets posed a growing threat to financial stability, in 2013 the RBNZ restricted the portion of banks' new residential mortgage lending that could have an LVR greater than 80 per cent.
- In the United Kingdom, the Financial Policy Committee (FPC) can issue directions on sectoral capital requirements and set the counter-cyclical capital buffer, and has asked for the power to impose a time-varying leverage ratio.<sup>43</sup> It can recommend other changes to the United Kingdom Treasury or other regulators to address systemic risks, including changes to regulation such as when existing rules are out of date or activity has moved beyond the regulatory perimeter.

China has intensive state involvement in the financial sector, both through state-owned banks and its regulatory regime. Authorities use caps on LVRs, credit growth ceilings, counter-cyclical capital requirements, reserve requirements, taxes and property ownership limits.<sup>44</sup>

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41 Menon 2013, *Securing Price Stability as Singapore Restructures*, address to Asian Bureau of Finance and Economics Research Opening Gala Dinner, 21 May, Singapore.

42 RBNZ 2014, *Macro-prudential policy – FAQ*, RBNZ, Wellington, viewed 18 June 2014, <[http://www.rbnz.govt.nz/financial\\_stability/macro-prudential\\_policy/5163689.html](http://www.rbnz.govt.nz/financial_stability/macro-prudential_policy/5163689.html)>.

43 Bank of England (BoE) 2013, *Macroprudential policy at the Bank of England*, Bank of England Quarterly Bulletin, Quarter 3, BoE, London.

44 Lim, C, Columba, F, Costa, A, Kongsamut, P, Otani, A, Saiyid, M, Wezel, T and X Wu 2011, *Macroprudential Policy: What Instruments and How to Use Them? Lessons from Country Experience*, IMF Working Paper WP/11/238, IMF, Washington DC.

## Policy options for consultation

### Assess the prudential perimeter

Along with needing to identify risks outside the prudential perimeter, regulators must also be able to respond to those risks. In the current system, where the majority of the tools available to address systemic risks reside with APRA, and can only be applied *within* the prudential perimeter, this may be problematic. The Inquiry welcomes stakeholder views on the most appropriate way to ensure such risks can be managed.

One option would be to allow for some permeability of the prudential perimeter. That is, on the rare occasion a systemic risk is identified outside the prudential perimeter, some mechanism allows for affected institutions or activities to be brought within APRA's remit and subjected to more intensive regulation and supervision. This may include when an institution or activity becomes of such size, interconnectedness, complexity or market importance that it poses a risk to overall system stability.<sup>45</sup>

Currently, legislation must be passed to enact such a change. This has the advantage of strong accountability, but can also take a significant amount of time. A more timely option could be to allow the appropriate Minister to designate institutions or activities to be brought into APRA's purview, on systemic risk grounds, on advice from the RBA or CFR. This may be advantageous if significant delays in addressing the risk may let it build up further. Any such mechanism would need a high threshold for activation, with clear processes to ensure accountability for the decision.

Heightened regulatory and supervisory intensity for activities that pose systemic risk is not out of step with international practice. Some jurisdictions are setting thresholds for defining systemically important institutions. The Dodd-Frank Act authorises the Financial Stability Oversight Council to issue rules to require prudential supervision of systemically important non-bank entities or FMI entities.

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<sup>45</sup> For example, see the proposals in Financial Stability Board (FSB) 2014, *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, consultative document, FSB, Basel.

*The Inquiry seeks views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Establish a mechanism, such as designation by the relevant Minister on advice from the RBA or CFR, to adjust the prudential perimeter to apply heightened regulatory and supervisory intensity to institutions or activities that pose systemic risks.

*The Inquiry seeks further information on the following areas:*

- Is new legislation the most appropriate mechanism to adjust the prudential perimeter to respond to systemic risks, or could a more timely mechanism be of benefit? What alternative mechanisms could be used?
- What accountability processes would be necessary to accompany any new mechanism?
- What criteria could determine when an institution or activity was subject to heightened regulatory and supervisory intensity?

### Additional macroprudential powers

APRA and the RBA have argued on a number of occasions that APRA's existing toolset is adequate to undertake macroprudential supervision.<sup>46</sup> APRA has the ability to vary its intensity of supervision, prudential standards and capital requirements through the economic cycle. Although APRA has not publicly stated under what circumstances it will use it, the counter-cyclical capital buffer enshrined in Basel III is also available. The RBA does not have specific macroprudential tools in the traditional sense, but it does extensively use public communications to address concerns and manage particular risks.

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<sup>46</sup> See Australian Prudential Regulation Authority (APRA) and Reserve Bank of Australia (RBA) 2012, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework*, APRA and RBA, Sydney; Ellis, L 2012, *Macroprudential Policy: A Suite of Tools or a State of Mind?*, speech to Paul Woolley Centre for Capital Market Dysfunctionality Annual Conference, 11 October, Sydney; and Edey, M 2012, *Macroprudential Supervision and the Role of Central Banks*, remarks to the Regional Policy Forum on Financial Stability and Macroprudential Supervision, 28 September, Beijing.

For two decades, Australia has effectively navigated systemic risk without the kinds of tools being introduced in some countries. Although there is no guarantee this will always be the case, Australia should be cautious regarding unproven tools while empirical evidence of their effectiveness remains limited.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Introduce specific macroprudential policy tools.

*The Inquiry seeks further information on the following areas:*

- Are there specific macroprudential tools that Australia should adopt to manage systemic risk?
- What agency or agencies should have these macroprudential tools?

## Stress testing

In its recent Financial Sector Assessment Program, the IMF recommended that Australian regulators enhance their stress-testing capabilities. In particular, that APRA devotes more resources to stress testing and the RBA develops the capability to undertake in-house macroeconomic stress tests.

A number of other jurisdictions make extensive use of stress testing. In some cases, such as in the United States, stress tests are a key input into supervision, helping to assess institutions' compliance with prudential standards. Enhanced capabilities could aid APRA in supervising institutions, and assist both APRA and the RBA in monitoring systemic risk. Given the differences in their mandates and areas of focus, having both agencies conduct independent stress tests would provide a useful check and balance on the process. It would also encourage cross-agency discussion and deeper analysis to understand any differences in outcome.

However, robust stress testing has a resource cost for both regulators and industry. During stress testing, industry participants are typically required to provide data or respond to questions — some large banks involved in United States and European Union stress tests reported up to 100 staff members being used in the process.<sup>47</sup> Stress

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<sup>47</sup> Moody's 2013, *Stress Testing: European Edition, Risk Perspectives*, vol. 1, September, Moody's Corporation, New York.

testing is likely to be on the lower end of the cost spectrum compared to other options for improving financial stability.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Australian regulators make greater use of stress testing with appropriate resourcing.

### Box 5.3: A high-level scenario analysis

The FSI Secretariat, in conjunction with the Treasury and the RBA, conducted a qualitative scenario analysis as a simple stress test. The test was a useful tool to examine systematically, at a high level, the effect of several hypothetical financial shocks on the financial system. It did not examine the robustness of individual institutions' balance sheets to these shocks or the adequacy of capital.

This work suggested that financial and economic shocks would have to be severe, and several would need to occur at once, to threaten the viability of the Australian financial system. This is similar to the conclusions made by APRA and the IMF in 2012 when they performed their own stress tests of the banking system.<sup>48</sup>

The exercise found:

- A prolonged and pronounced deflation in housing prices would have a direct effect on the capital adequacy of the banking system, impairing the ability of banks to intermediate funds and leading to a large economic adjustment. Weaker economic outcomes could lead to a further deterioration of bank balance sheets, which would exacerbate already impaired bank lending conditions.
- A severe shock to international financial markets that reduces or removes access to foreign funding for Australian financial institutions would sharply increase the interest rates on bank lending and significantly reduce bank lending across the economy. This would in part be offset by an easing in monetary policy. Weaker economic outcomes could increase non-performing loans and deteriorate banks' asset quality, which would further increase the cost, and reduce the availability, of credit.
- An offshore growth shock from a large trading partner would largely have an indirect effect on the financial system — weaker economic outcomes could lead to an increase in non-performing loans and a deterioration of bank balance sheets. The magnitude of the effect would depend largely on the degree to which financial imbalances had built up prior to the shock.

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48 See the following publications: International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF Country Report No. 12/308, IMF, Washington DC, and Laker, J 2012, *The Australian banking system under stress – again?*, AB+F Randstad Leaders Lecture 2012, 8 November, Brisbane.

**Box 5.3: A high-level scenario analysis (cont.)**

The scenarios considered mainly affected the financial system in two dimensions: through access to and management of liquidity and through compromising the capital base of the banks. However, many of the regulatory measures put in place since the North Atlantic financial crisis, as well as some of the measures and mechanisms financial institutions have implemented themselves, have served to increase the resilience of the financial system to shocks since the GFC.

## Implementation of international prudential frameworks

Australia is an active member of many international policy and standard-setting bodies, including the FSB, BCBS and IAIS. Using these positions, Australia has been successful in influencing international standards to be broadly appropriate for the domestic environment.

As a global benchmark, the Basel framework is not designed to the particular circumstances of any one country. It is designed to apply a common minimum to a broad range of countries with different financial systems. A number of submissions, including from APRA, note that Australia has decided on a stricter approach to calculating capital ratios than the Basel III baseline. Further, in the case of capital requirements and the liquidity coverage ratio, APRA is implementing changes faster than a number of other countries.

Submissions raise three concerns, which are assessed in this section:

1. More conservative capital definitions mean that Australian banks use more equity funding than overseas peers, placing Australian banks at a competitive disadvantage.
2. Differences in capital definitions reduce transparency and make it difficult to compare capital ratios in Australia to those overseas. This can make Australian banks seem less sound than they really are.
3. Faster implementation of Basel requirements puts Australian banks at a competitive disadvantage in overseas markets, until other jurisdictions complete their own implementation.

## Preliminary assessment

### *Observation*

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

### Capital requirements

Prudential frameworks have many different aspects, making it difficult to compare the relative strictness of one regime to another. Table 5.1 shows a number of these different settings for a variety of countries; in general, Australia is in line with the Basel framework minimum requirements, while a number of countries have higher requirements. On this basis, Australia's overall framework does not seem to require excessive capital levels.

Table 5.1: Country implementation of Basel III

	Common equity tier 1 capital	Minimum tier 1 capital	Total capital	Add-on for systemically important banks	Leverage ratio
BCBS	4.5%	6.0%	8.0%	1.0-3.5% (G-SIB)	3.0%
Australia	4.5%	6.0%	8.0%	1.0%	TBA
European Union	4.5%	6.0%	8.0%	2.0% <sup>(c)</sup>	TBA
Canada	4.5%	6.0%	8.0%	1.0%	3.0%
China	5.0%	6.0%	8.0%	1.0%	4.0%
Hong Kong	4.5%	6.0%	8.0%	1.0-3.5% (proposed)	TBA
India	5.5%	7.0%	9.0%	0.2-0.8%	4.5%
Japan	4.5%	6.0%	8.0%	TBA	TBA
Netherlands	4.5%	6.0%	8.0%	3.0%	TBA
Singapore	6.5%	8.0%	10.0%	TBA	TBA
Sweden	4.5%	6.0%	8.0%	5.0% <sup>(b)</sup>	TBA
Switzerland	4.5%	6.0%	8.0%	1.0-6.0% <sup>(c)</sup>	4.5%
United Kingdom	4.5%	6.0%	8.0%	TBA	3.0%
United States	4.5%	6.0%	8.0%	TBA	5.0-6.0%

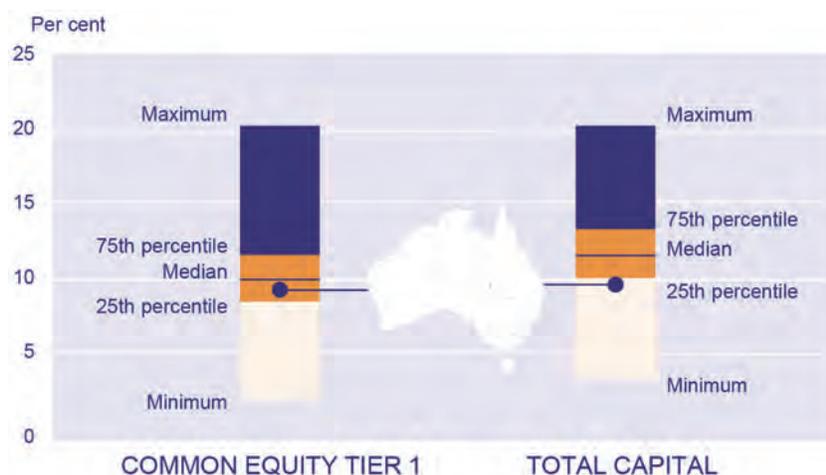
(a) This is the Other Systemically Important Institution (O-SII) buffer as set out in the Directive. Individual jurisdictions have discretion to implement a higher surcharge.  
 (b) Of this 5 per cent, 3 per cent is the Domestic Systemically Important Bank (D-SIB) buffer and 2 per cent is a Pillar 2 surcharge applicable to D-SIBs.  
 (c) A much higher capital conservation buffer of up to 8.5 per cent will also apply to systemically important banks.

Sources: APRA, BCBS, Boards of Governors of the United States Federal Reserve System, China Banking Regulatory Commission, De Nederlandsche Bank, European Banking Authority, Swiss Financial Market Supervisory Authority (FINMA), Hong Kong Monetary Authority, Japan Financial Services Agency, Monetary Authority of Singapore, Office of the Superintendent of Financial Institutions Canada, Reserve Bank of India, Sveriges Riksbank, United Kingdom Prudential Regulation Authority.

Submissions raise concerns that Australia’s approach to calculating capital ratios leads to Australian banks requiring higher levels of equity funding than international peers. In fact, banks’ actual capital ratios do not appear excessively high, including when compared to countries at a similar level of financial development (Chart 5.3).

**Chart 5.3: Global distribution of banks’ actual capital ratios<sup>(a)</sup>**

As at end June 2013



(a) Calculated on a consistent basis across countries by the BCBS. The sample includes 102 Group 1 banks - those with at least €3 billion in tier 1 capital and that are internationally active - from 21 BCBS countries.

Source: BCBS.

A recent BCBS review of Australia’s implementation of the Basel framework identified 27 areas in which APRA’s implementation, taking advantage of national discretions, was more conservative than the Basel baseline.<sup>49</sup> However, Australia was also less conservative than the baseline in several areas. Similar reviews for China, Brazil and Canada identified 17, 20 and 7 areas respectively that were more conservative.<sup>50</sup> These are not the same areas as Australia (or each other), making comparison difficult.

Switzerland and Singapore were ‘super equivalent’ to the Basel framework through setting higher capital ratios rather than through stricter capital definitions.

Unfortunately, these BCBS reviews currently cover only a limited number of countries.

49 Bank for International Settlements (BIS) 2014, *Regulatory Consistency Assessment Program (RCAP) Assessment of Basel III Regulations – Australia*, BIS, Basel.

50 Bank for International Settlements (BIS) 2013, *Regulatory Consistency Assessment Program (RCAP) Assessment of Basel III Regulations – China*, BIS, Basel, BIS 2013, *Regulatory Consistency Assessment Program (RCAP) Assessment of Basel III Regulations in Brazil*, BIS, Basel and BIS 2014, *Regulatory Consistency Assessment Program (RCAP) Assessment of Basel III Regulations – Canada*, BIS, Basel.

Differences between capital ratios internationally are also driven by diversity in minimum capital requirements, leverage ratios, additional capital requirements for systemically important banks and regulator-imposed non-public capital requirements. Calculating what is required in Australia compared to other jurisdictions is therefore very difficult.

The BCBS collects data on bank capital ratios on a consistent basis among its member countries. These data show that Australian banks are roughly ‘middle of the pack’ in terms of common equity tier 1 capital ratios when calculated on this basis. Given that banks in many countries are still raising capital to meet incoming Basel standards, Australia’s prudential framework does not seem to require excessive capital levels.

### International comparability

Some submissions are concerned that calculation differences make Australian banks’ capital ratios appear lower than if they had been calculated under many other jurisdictions’ implementation of the Basel rules. The exact magnitude of this difference is uncertain. It will vary by balance sheet composition and the comparator jurisdiction. Table 5.2 shows how Australian bank common equity tier 1 capital ratios change when self-calculated in an ‘internationally harmonised’ fashion – essentially, trying to adopt the Basel framework with minimal discretionary changes. These self-calculated capital ratios are higher than those calculated by the BCBS (Chart 5.3), but still fall around the middle of the range relative to other countries.

**Table 5.2 Common equity tier 1 capital ratios**  
In 2013 bank annual reports

	<b>APRA capital ratio</b>	<b>Self-reported internationally harmonised capital ratio</b>	<b>Difference</b>
ANZ	8.5%	10.8%	2.3%
CBA	8.2%	11.0%	2.8%
NAB	8.4%	10.3%	1.8%
WBC	9.1%	11.6%	2.5%
Memo: APRA submission	8.3%	10.2%	1.9%
Memo: CBA submission	8.5%	11.4%	2.9%

Sources: APRA submission to the Inquiry, CBA submission to FSI, bank annual reports.

The difficulty in calculating consistent capital ratios lends weight to claims that international investors do not make such comparisons. The differences may be to the detriment of Australian banks, as they result in reported capital ratios appearing lower than if they had been calculated in some other countries. Although some Australian banks publish internationally harmonised ratios, as in Table 5.2, they argue that

investors are sceptical of their accuracy.<sup>51</sup> In addition, where banks are issuing debt that contains ‘triggers’ based on their capital ratio, Australian banks may be seen to have less of a buffer above the trigger. This may raise the costs of issuing such instruments.

### Implementation schedule

The Basel III capital ratio requirements will be fully implemented in Australia by the start of 2016, while the Liquidity Coverage Ratio (LCR) will start in full in 2015. This is sooner than in many other jurisdictions, which are phasing the new requirements in over a longer period. Submissions argue that implementing these requirements ahead of other countries places Australian banks at a competitive disadvantage during the transition.

Australia is not the only jurisdiction adopting Basel III without the extended transitional phase-in period. Other countries with strong financial systems, including Canada, New Zealand, Singapore and some of the Nordic countries, are also requiring full compliance before the end of 2019, the allowable transition period.

In addition, Australia’s major banks are well placed to meet the new capital requirements.<sup>52</sup> This reflects both that Australian banks have been building up capital in anticipation of the incoming requirements, and that the capital requirements were not significantly higher than banks’ existing capital levels. Compared to some jurisdictions, such as particular European nations where post-GFC bank capitalisation was very low, Australia had less need to use extended phase-in periods.

Early implementation can have a cost to the extent that it requires Australian banks to move to more expensive capital funding earlier than they might otherwise have and faster than their international peers. RBA Governor Stevens noted it is important to take advantage of the current good macroeconomic environment to build capital, as it will not last forever: “This is a reason to go faster, rather than slower, in accumulating capital to higher minima, while one can”.<sup>53</sup>

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51 Internationally harmonised capital ratios aim to recalculate the banks’ capital ratio as if the bank were subject to the ‘baseline’ Basel rules (with no national discretion applied) or subject to the rules in another specific country.

52 APRA 2013, ‘ADI Industry Risks’, *APRA Insight*, issue 2 notes that: “Having strengthened their capital positions over recent years in response to market expectations and in anticipation of higher Basel III requirements, all ADIs already meet this minimum requirement, with current CET1 ratios above 7 per cent”.

53 Stevens, G 2014, *Financial Regulation: Some Observations*, speech to Federal Reserve Bank of San Francisco’s Symposium on Asian Banking and Finance, 10 June, San Francisco.

For liquidity standards, Australia arguably does not need a phase-in period because of the Committed Liquidity Facility (CLF) that was introduced to account for the low levels of Government debt in Australia. The CLF effectively allows easier compliance with the LCR and is not available in most other countries. However, banks will be required to demonstrate to APRA that they have taken ‘all reasonable steps’ to meet the LCR through their own balance sheet management, before relying on the CLF for this purpose. Moreover, the majority of global internationally active banks already meet the LCR requirement.

## Policy options for consultation

### Calibrate the prudential framework

The Inquiry considers it appropriate for Australia to maintain its compliance with global standards, such as the Basel framework for banking.<sup>54</sup> There would be significant costs to Australia if it did not materially adopt the minimum standards set out in these agreements, including:

- Australia’s reduced integration with the international financial system
- Reduced ability to influence future global standards
- Less international comparability
- Australia being seen as more risky, potentially raising financial institutions’ funding costs
- Opportunities for overseas regulators to impose more restrictive requirements on Australian financial institutions than at present, to compensate for a lack of regulatory comparability

Historically, Australia has taken a stronger approach to financial stability than required under global standards. This contributed to the robustness of the Australian financial system during the GFC, relative to North Atlantic countries, and to an international reputation for a sound system. Since then, global efforts to improve financial stability have resulted in stronger frameworks and requirements in many other countries than was previously the case – and some increase in Australia’s requirements.

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<sup>54</sup> Australia may adopt international standards through Government commitments, legislation, domestic standard setting, and regulator rules and guidance.

Starting from the premise that, at a minimum, Australia's prudential framework should be consistent with the global median, the Inquiry seeks stakeholder views on where Australia should aim to sit on the global financial stability spectrum given these global changes.

At one end of the spectrum, Australia may be comfortable with where the global settings have settled and see no need to go beyond this standard for its prudential framework. At the other end, Australia may want to be above the global median, particularly where there are clear Australian policy reasons for lifting the bar; for example, Australia is a capital importing nation and a stronger system may help assure international investors that Australia is a safe and attractive investment destination.

The weight of evidence suggests that having a more conservative approach to prudential requirements in the past has not placed Australian banks at a significant competitive disadvantage.

- Historically, where the gap between Australia's approach to capital and those in large economies such as the United States and United Kingdom was much greater, Australian banks were profitable.
- To the extent that Australian banks are at a competitive disadvantage from being more conservative than the rest of the world, this should have decreased with Basel III, which closes the gap between requirements in Australia and those in several major markets.
- Overseas bank branches operating in Australia do not comply with Australian capital requirements. Evidence does not suggest overseas branches are more competitive in Australia.

In addition, a growing body of work suggests that the social costs to higher bank equity funding are smaller than is often presumed. The argument is broadly that better capitalised banks are less risky, lowering the cost of wholesale debt and deposit funding.<sup>55</sup> Further, although equity may be more privately expensive to banks, this is affected by the different tax treatment of debt and equity funding.<sup>56</sup> Thus, from society's perspective, which accounts for the foregone tax revenue from debt funding, equity may not be so expensive.

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55 See for example Admati, A and Helwig, M 2013, *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*, Princeton Press, Princeton NJ, and Babihuga, R and Spaltro, M 2014, *Bank Funding Costs for International Banks*, IMF Working Paper WP/14/71, IMF, Washington DC.

56 This difference is possibly less pronounced in Australia, however, due to the dividend imputation system — see the *Funding* chapter for further discussion.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Maintain the current calibration of Australia’s prudential framework.
- Calibrate Australia’s prudential framework, in aggregate, to be more conservative than the global median. This does not mean that all individual aspects of the framework need to be more conservative.

*The Inquiry seeks further information on the following area:*

Is there any argument for calibrating Australia’s overall prudential framework to be less conservative than the global median?

### International comparability of Australia’s prudential requirements

APRA’s approach to implementing parts of the Basel framework has been stricter than the international standards imply. This reflects a tailoring of the regulatory capital framework to, in APRA’s view, better reflect the capital adequacy of ADIs. The main differences are stronger definitions of capital and floors for loss given default (LGD) estimates for residential mortgage exposures under the internal ratings-based approach to credit risk. APRA does not include certain capital items allowed under Basel III that are not truly loss absorbing, as these were included to accommodate weak banking systems in some jurisdictions. Australia has imposed LGD floors as historical data on losses used to calculate risk weights may not reflect a true downturn, given Australia has not had a major recession in two decades.

A number of submissions note that these differences can create difficulties for Australian banks; for example, making them appear less well capitalised than their international peers, even where there is no real difference. A lack of transparency could prove a disadvantage in funding markets, particularly where an instrument has a trigger based on a bank’s capital ratio. However, banks can and do publish internationally harmonised capital ratios to account for the difference. One might expect sophisticated international investors to be aware of differences in regulatory approaches.

To avoid banks relying on ‘unofficial’ internationally harmonised capital ratios, which may not be seen as credible by international investors, robust, regulator-approved ratios could be published. APRA and industry are currently working to develop official reporting for this purpose. This would improve transparency at a relatively low cost.

A second option to improve transparency is to adopt the Basel framework for calculating prudential ratios, without national adjustment.<sup>57</sup> APRA could then use its discretion to set the headline capital ratio (or other prudential tools) at the level it felt appropriate to achieve the desired level of system safety. Switzerland has taken this approach, setting a much higher headline capital ratio for its medium-sized and large banks.<sup>58</sup> This option would also address banks' concerns about capital ratio triggers in some types of debt instruments, such as where the debt instrument converts to equity when the official capital ratio falls below a specified threshold.

There are difficulties with such an approach. First, there is no 'standard' Basel framework to work off — all countries have implemented the framework in different ways, and the framework includes scope for national discretion. Second, while it would be possible for APRA to reduce its use of national discretion, this may lead to rules that are less suited to Australia's particular circumstances. Third, allowing banks to include items in capital calculations that APRA deems to be significantly more uncertain in value, or less loss-absorbing, than current capital would increase the riskiness of the system and penalise more prudent banks that choose to hold larger portions of high-quality capital.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Develop public reporting of regulator-endorsed internationally harmonised capital ratios with the specific objective of improving transparency.
- Adopt an approach to calculating prudential ratios with a minimum of national discretion and calibrate system safety through the setting of headline requirements.

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<sup>57</sup> See, for example, CBA 2014, First round submission to the Financial System Inquiry.

<sup>58</sup> Bank for International Settlements (BIS) 2013, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III regulations – Switzerland*, BIS, Basel.

*The Inquiry seeks further information on the following areas:*

- Would adopting a more internationally consistent approach to calculating capital ratios materially change Australian banks' cost of accessing funding?
- How would using minimal national discretion distinguish between prudent banks that hold capital as currently defined and those that rely on less loss absorbing capital?
- How might APRA need to adjust minimum prudential requirements to ensure system safety is not altered if using minimal national discretion in calculating prudential ratios?

## Corporate governance

Good governance is a vital part of any corporation, both within and beyond the financial sector. The culture of an organisation, its appetite and its approach to managing risk ultimately flow from the policies and practices set at the very top. The rules and requirements set by regulators and internally within the institution will only go so far; an organisation's culture and risk appetite determine how an institution responds to the spirit of the requirements and circumstances that are not addressed by the rules.

Equally, weak corporate governance can have severe repercussions. This is particularly true within the financial sector, where failures in governance and risk management can have an effect on the entire financial system and broader economy. Overseas, financial institution boards' lack of understanding about the risks faced by their institutions, and an absence of robust governance frameworks through which they could monitor the risk-taking actions of management, were major contributors to the GFC.<sup>59</sup> The significant effect of the GFC on economic growth, employment and the financial system in many countries underscores the importance of strong governance frameworks.

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<sup>59</sup> G30 2012, *Towards Effective Governance of Financial Institutions*, G30 Special Report, G30 Working Group, Washington DC.

## Preliminary assessment

### *Observation*

To contribute to the effectiveness of the financial system, sound corporate governance requires clarity of the responsibilities and authority of boards and management. There are differences in the duties and requirements of governing bodies for different types of financial institutions and, within institutions, substantial regulator focus on boards has confused the delineation between the role of the board and that of management.

### Importance in the financial industry

Reflecting the importance of corporate governance to all industries, standards and requirements are placed on company boards and management from several sources. The *Corporations Act 2001* places a common set of requirements on all corporates to provide a baseline for corporate governance, including that the primary duty of the board is to the company. Listed entities are also subject to ASX's corporate governance standards, which aim to promote accountability to shareholders and maintain the integrity of the market. The latter incorporate disclosure standards, including risk management practices that assist shareholders and creditors assessing the risk appetite and practices of the company.

In the financial industry, the relevant prudential Acts provide that insurer directors and superannuation fund trustees place the interests of policyholders and members ahead of those of shareholders. There are no equivalent provisions for ADIs under the *Banking Act 1959*. Duties of governing bodies therefore differ across types of financial institutions. The Inquiry invites further information from stakeholders on whether the diversity of duties of governing bodies in different parts of the financial industry is appropriate.

Corporate governance prudential standards, set by APRA, are common for ADIs and insurers. These place requirements on the structure of boards and the independence of directors. The respective standards for superannuation do not have structure or independence requirements but do cover conflicts of interest. In 2013, the Government released a consultation paper on how best to ensure an appropriate provision for independent directors on superannuation trustee boards.<sup>60</sup> This included how independence could be defined and the optimal board structure.

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<sup>60</sup> Commonwealth of Australia 2013, *Better regulation and governance, enhanced transparency and improved competition in superannuation, Discussion paper*, Canberra.

There is a sound public policy rationale for requirements and oversight in the financial sector of corporate governance generally, and risk management specifically.<sup>61</sup> A function of the financial sector is to transform and manage financial risk. This can involve higher use of leverage, increasing the risk of stakeholders exposed to poor risk management. Appropriate frameworks, which enable institutions to understand and manage often complex risks, are crucial. Adequate reporting of these frameworks is important in promoting market discipline and allowing investors to make informed choices about the risks they take on.

Understanding and managing risk are particularly important, as excessive risk taking has the potential to disrupt the entire financial system and economy. This was evidenced during the GFC, demonstrating that, in the absence of good corporate governance, the benefits of appropriate Government interventions can be high.

Internationally, where the impact of the GFC was greatest, regulators have taken a strong approach to corporate governance in financial institutions. In a number of cases, other jurisdictions have placed significantly more onerous requirements on management and boards than in Australia. For example, in the United States, financial institutions are prevented from making capital distributions if stress-tests reveal weaknesses; in New Zealand the regulator can bring criminal cases against directors in specific circumstances, including misleading disclosures in offer documents; and in Europe, there are significant remuneration controls.

### The role of boards and management

Ultimately, the board is accountable for the actions of the institution. Good corporate governance across all industries involves clear and distinct duties performed by the board and senior management. A board's obligations are: overseeing, directing and monitoring the performance of the company; approving and overseeing strategic policies and frameworks, including for risk management; and satisfying itself that such policies and frameworks are effective. Management is responsible for operational day-to-day activities and implementing strategic policies and frameworks. Generally, boards oversee what management implements. In the Inquiry's view, although there is a public policy case for specific corporate governance requirements on financial institutions, there is no case for regulation to alter the delineation of responsibilities between boards and management.

A number of submissions raise concerns that APRA's requirements have become too prescriptive and do not respect the appropriate division between the responsibilities of the board and those of management. This includes where supervisory matters are

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<sup>61</sup> Tarullo, D 2014, *Corporate Governance and Prudential Regulation*, remarks at the Association of American Law Schools 2014 Midyear Meeting, 9 June, Washington DC.

referred by APRA directly to the board, which is often taken to imply the board itself must take responsive action. Many industry participants believe the requirements imply an excessive level of managerial ownership by the board and, in some cases, overstate the board's influence. Submissions argue that this diminishes boards' ability to focus on governance and strategic direction, hampering their capacity to perform their core functions.

This is not unique to Australia. Speaking in a United States context, Federal Reserve Governor Tarullo noted:

*“But it has perhaps become a little too reflexive on the part of regulators to jump from the observation that a regulation is important to the conclusion that the board must certify compliance through its own processes. We should probably be somewhat more selective in creating the regulatory checklist for board compliance and regular consideration”.*<sup>62</sup>

Submissions and consultation also revealed discontent with the increased management time and attention on governance and regulatory matters that require a number of levels of review — including independent reviews requiring the appointment of external consultants — adding to the cost of compliance.

Given the breadth of concern, the Inquiry invites further information from stakeholders on where they specifically believe corporate governance requirements unduly place managerial responsibilities on boards. Consultation to date suggests that at least part of the issue appears to be uncertainty about APRA's expectations of how boards need to meet governance requirements.

## Remuneration

Remuneration structures and policies are a specific aspect of corporate governance that can materially affect the risks taken by the institution. In the lead-up to the GFC, compensation practices around the world contributed to a culture of excessive risk taking within firms, as short-term gains were rewarded with little regard for the longer-term risks.<sup>63</sup> On the cause of the crisis, Adair Turner concluded that “inappropriate incentive structures played a role in encouraging behaviour which

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<sup>62</sup> Tarullo, D 2014, *Corporate Governance and Prudential Regulation*, Remarks to Association of American Law Schools Midyear Meeting, 9 June, Washington DC.

<sup>63</sup> See for example Blinder, A 2009, 'Crazy Compensation and the Crisis', *The Wall Street Journal*, 28 May and Rajan, R 2008, 'Bankers' pay is deeply flawed', *Financial Times*, 9 January.

contributed to the financial crisis” although he also noted that they likely made a smaller contribution than other factors.<sup>64</sup>

The FSB has produced principles to address risk created by remuneration structures. Broadly, these involve linking compensation to the long-term performance of investments to discourage excessive short-term risk taking. Overseas regulators have taken a variety of approaches, ranging from high-level principles on how remuneration should be set – including the ability to ‘claw back’ past bonuses – through to regulator approval for bonuses paid.

APRA considers remuneration in its supervision of financial institutions. To date, Australia has taken a principles-based approach to remuneration, requiring financial institutions to align incentives with long-term performance. This appears appropriate in the Australian context, where there have been fewer financial failures and where remuneration packages are more contained than in some other countries.

The more prescriptive approach to remuneration policy taken in some jurisdictions, such as the regulator approving senior management bonuses, is unlikely to be appropriate for Australia. It presupposes that the regulator is better placed to assess the performance of individuals than the institution itself, or that the regulator has specific capacity in this regard. It also has challenges, such as the possibility the regulator will be overly risk averse due to public scrutiny and popular political pressure to lower bonuses. This could lower risk taking below an efficient level.

## Policy options for consultation

### Requirements on boards

Submissions are critical that the current regulatory and supervisory system does not delineate appropriately between the role of boards and management.

Consultations suggest that part of this may reflect a lack of understanding about APRA’s expectations of boards. Reflecting a desire to not be in breach of the requirements, this has resulted in disproportionate compliance measures by a number of institutions. According to APRA, its standards do not require boards to micro-manage the organisation. Instead, they aim to ensure boards implement appropriate policies and frameworks, particularly relating to risk, and are satisfied that these policies are effective. In addition, correspondence is often addressed to boards with the intention of ensuring that they are aware of APRA’s concerns and ensure that

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64 Turner, A 2009, *The Turner Review: A regulatory response to the global banking crisis*, Financial Services Authority, London.

management addresses them, not for the board's direct action. If this is the case, APRA should clarify its expectation of boards to dispel misconceptions. The Inquiry notes that actions are already underway in this regard.<sup>65</sup> This should assist with concerns in this area.

A further step would be for regulators to review their frameworks for corporate governance requirements, potentially with input from independent advice.<sup>66</sup> A review would aim to determine whether requirements imposed upon boards are consistent with the fundamental obligations of a company director. This could be used to identify areas where management could more appropriately undertake such obligations.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Review prudential requirements on boards to ensure they do not draw boards into operational matters.
- Regulators continue to clarify their expectations on the role of boards.

*The Inquiry seeks further information on the following area:*

Is it appropriate for directors in different parts of the financial system to have different duties? For example, differences between the duties of directors of banks and insurers and trustees of superannuation funds. Who should directors' primary duty be to?

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<sup>65</sup> See Littrell, C 2014, Letter to all CEOs of ADIs, general insurers and life companies, 8 May.

<sup>66</sup> CBA 2014, First round submission to the Financial System Inquiry, page 93.

## 6: Consumer outcomes

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The financial system should meet the financial needs of Australians. Consumer outcomes can be enhanced by supporting effective competition in the system, which can drive lower prices and encourage innovation. Further, the regulatory framework of the Australian financial system is designed to protect consumers through prudential regulation, generic consumer regulation, and licensing and conduct obligations. Fundamental to the financial system operating effectively is the appropriate allocation of risk between participants. Consumers, like other participants, must take responsibility for both the risk and reward of their financial decisions.

The Inquiry has made the following observations about consumer outcomes in the financial system:

- The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.
- Affordable quality financial advice can bring significant benefits for consumers. Improving the standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower-cost scaled advice.
- Technological developments have the potential to reduce insurance pooling. This will reduce premiums for some consumers; however, others will face increased premiums, or be excluded from access to insurance. Underinsurance may occur for a number of reasons including personal choice, behavioural biases, affordability, and lack of adequate information or advice on the level of insurance needed.

### Context

This chapter focuses on the issues confronting retail consumers (individuals and households) when they engage with the financial sector. Some of the issues discussed are also relevant to many small businesses. In some cases, small businesses are similar to retail consumers in their level of sophistication and bargaining power. This chapter specifically discusses loans for small businesses, and the *Funding* chapter considers the funding needs of businesses in general.

To meet consumer needs, the Inquiry considers the financial system should deliver five outcomes:<sup>1</sup>

1. Consumers should have access to products and services that help them meet their individual financial needs. Consumers need to be able to make and receive payments, borrow, invest and manage risk. Products should be designed to meet the needs of consumers.
2. Consumers should have access to the information, advice and education necessary to make effective decisions about products and services that help them meet their financial needs. Informed consumers can better stimulate effective competition, driving system efficiency.
3. Consumers should have confidence and trust in the financial system and be able to expect fair treatment. Effective regulation that minimises misconduct and promotes fair outcomes will drive confidence and trust in the financial system.
4. Financial services and products should meet the purposes for which they are sold. Products and services should be accurately described, and perform as they are described, especially in the trade-off between risk and return.
5. Consumers should have access to timely, low-cost and efficient dispute resolution and remedies when problems arise. Effective avenues for redress provide access to justice for consumers and promote confidence and trust in the system.

In this chapter, consumer outcomes will be assessed against these five outcomes.

## Consumer protection framework in financial services

Prudential regulation by APRA provides an important mechanism for protecting depositors, insurance policyholders and superannuation fund members, as discussed in the *Stability* chapter. Prudential regulation is a fundamental consumer protection mechanism, which operates as a preventative measure to promote sustainable financial institutions that can deliver on their financial promises.

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<sup>1</sup> Similar high-level principles were endorsed by the G20 Finance Ministers and Central Bank Governors in 2011, <[www.oecd.org/daf/fin/financial-markets/48892010.pdf](http://www.oecd.org/daf/fin/financial-markets/48892010.pdf)>. In addition to the outcomes discussed in this chapter, these principles recognise the importance of competition in driving consumer outcomes, as discussed in the *Competition* chapter, and the protection of consumer data and privacy, discussed in the *Technology* chapter.

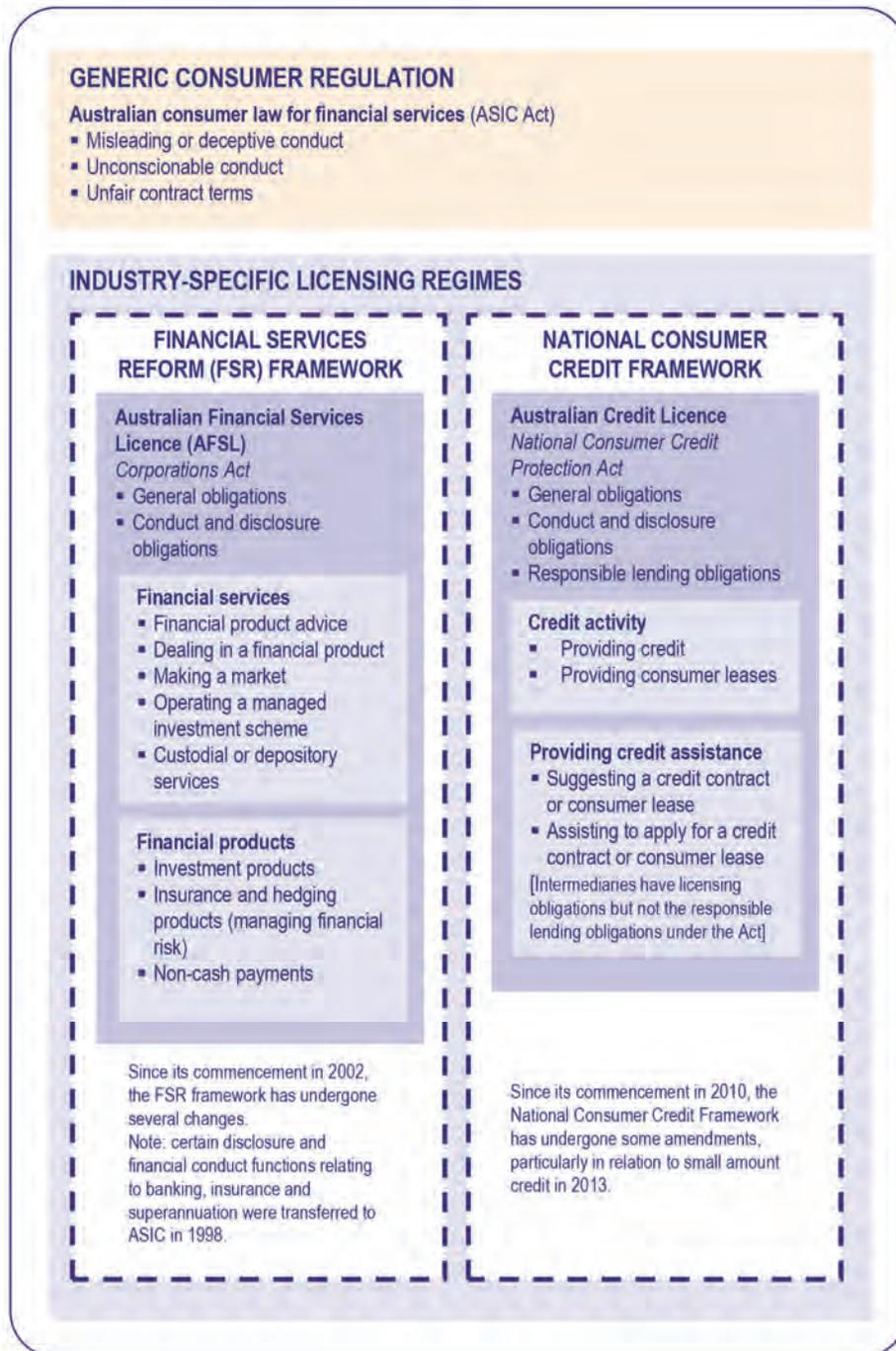
The framework for non-prudential regulation of financial services consists of two tiers:

1. **Generic consumer regulation** contained in the *Australian Securities and Investments Commission Act 2001* (ASIC Act), which covers all financial products and services, including credit. The provisions of the ASIC Act reflect the relevant provisions of the Australian Consumer Law and give ASIC responsibility for administering these provisions.
2. **Industry-specific consumer regulation**, which includes the licensing, conduct and disclosure regimes as set out in the *Corporations Act 2001* and the *National Consumer Credit Protection Act 2009*.

This framework reflects the Wallis Inquiry's view that ASIC should have exclusive responsibility for consumer protection (outside prudential regulation) in the financial sector. Industry-specific consumer regulation offers the benefit of preventing some consumer detriment on an ex-ante basis through licensing and positive conduct obligations, rather than simply providing remedies for dealing with misconduct after it has emerged.

There is a clear requirement for a balanced and effective consumer protection framework, including industry-specific consumer regulation in the financial sector. This is due to the: complexity of financial products; limitations of consumer financial literacy and engagement; significant (and often long-term) consequences of poor financial decisions; and propensity for consumer decision making to be biased or influenced by behavioural factors. Figure 6.1 shows the consumer protection regime in Australia as currently administered by ASIC.

**Figure 6.1: The regulatory framework for consumer protection in financial services (non-prudential)**



## The Financial Services Reform (FSR) framework

The Wallis Inquiry intended the FSR framework to apply across the financial services industry,<sup>2</sup> to both prudentially regulated and non-prudentially regulated entities. It was concerned about the impact of fragmented regulation on an industry that was consolidating across regulatory boundaries – and where product distinctions were blurring.

Since the FSR framework was introduced in 2001, changes have been made to the consumer protection regime, including:

- Ongoing attempts to improve the quality and usefulness of disclosure documents<sup>3</sup>
- Introducing the financial claims scheme (FCS) to protect depositors of authorised deposit-taking institutions (ADIs) and policyholders of general insurance companies from potential losses, should these institutions fail<sup>4</sup>
- Adding more sector-specific rules and exemptions through legislation, regulations, and ASIC's exemption and modification powers

## The National Consumer Credit framework

In 2010, the *National Consumer Credit Protection Act 2009* (NCCP Act) commenced, which includes the National Credit Code (NCC) as Schedule 1 to the Act. The NCCP Act replaced the previous state-based consumer credit codes and the Uniform Consumer Credit Code. The NCCP Act, which is administered by ASIC, introduced licensing and responsible lending obligations where credit or credit assistance is provided for personal, domestic and household purposes and also for residential investment loans. Submissions support the introduction of this framework, saying it has improved lending and mortgage broking practices.

In 2013, the NCCP Act was amended to introduce enhanced financial hardship rules, additional obligations on small amount, or 'payday', lenders and interest rate caps on all loans where the credit provider is not an ADI.

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2 Although significant carve-outs were introduced for basic deposit products and basic insurance products.

3 For example, the Government recently introduced shorter product disclosure statements for superannuation, margin lending products and simple managed investment products

4 Note that the Financial Claims Scheme is discussed separately in the *Stability* chapter.

## Assessing the regulatory framework

The regulatory framework relies on effective enforcement by the regulator. In some cases, the current framework may not need substantial change. Instead, consumer outcomes may be improved through better or more intensive supervision or enforcement of existing rules. Enforcement and the adequacy of penalties are discussed in the *Regulatory architecture* chapter. Further, in some cases, industry may be able to play a greater role in improving consumer outcomes. Greater supervision, more effective enforcement and/or industry self-regulation may be appropriate alternatives to further regulation, which may reduce innovation and competition or result in leave some consumer needs partially or wholly unmet.<sup>5</sup>

## Disclosure

To make decisions about financial products and services, consumers will collect information from many sources and may be influenced by many factors, but they also need access to accurate information from product issuers. The format of information may influence the degree to which consumers can effectively use the information.

The Wallis Inquiry's approach to consumer regulation was based primarily on disclosure. It did not restrict either the design of financial products or the type of financial products that could be marketed to retail clients. The focus of consumer protection was on regulating disclosure rather than products themselves. The disclosure regime was implemented as a principles-based approach to allow maximum flexibility for product issuers. However, it has subsequently been driven by an industry culture of legal compliance, rather than a focus on how best to inform consumers. This has resulted in lengthy and complex documents, rather than short, targeted documents that highlight product features, risks and rewards.

Although disclosure is an important part of the regulatory regime for providing financial products and services, alone it has not been sufficient to enable consumers to make informed decisions and consistently purchase financial products and services that meet their needs. Consumers are often disengaged and do not invest the time — and some consumers also lack the financial literacy skills — to understand disclosure documents. Disclosure has also been costly for industry. These problems remain despite numerous efforts to improve the regime.

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<sup>5</sup> Following the implementation of the Retail Distribution Review in the UK, a number of major UK banks stopped providing wealth management advice to those with only moderate amounts to invest. See also Cass Consulting, City University, Cass Business School, 2013, *The impact of the RDR on the UK's market for financial advice, challenge and opportunity*, London.

Disclosure for financial products and services is important for a range of participants:

- **Consumers** – helping them make informed, efficient choices by understanding the features of a product, whether it is suitable for purpose, its terms and conditions, its risk and price, and any conflicts of interest involving the provider. Disclosure is designed to minimise information asymmetry. Informed consumers can also drive competition between providers.
- **Intermediaries** (financial advisers, analysts, dealers, comparators and mortgage brokers) – helping them understand the detailed features of a product and assess its suitability for particular clients, and enabling comparison between products.
- **Financial product and service providers** – defining the product or service they are providing or advising on, allocating risk, and defining the legal terms and conditions of the product or service, which can be relied on in case of a dispute.

Although submissions recognise that disclosure has a role to play, many argue that it has not always been effective at informing consumers about the features and risks of financial products. There was no strong proposal for reviewing the prospectus regime in submissions. The Inquiry has therefore focused on the product disclosure statement (PDS) and credit disclosure regimes.

### Current disclosure obligations

The current regulatory regime requires all financial services licensees (and their authorised representatives) to give consumers information about their services via a Financial Services Guide (FSG), while personal advice must be documented through a Statement of Advice (SOA).

Financial product issuers are required to prepare a PDS covering the product's characteristics, risks and fee structure. PDSs were intended to provide concise and directed information to consumers, as compared with the more principles-based, open-ended prospectus requirements that continue to apply to securities and debentures.<sup>6</sup> In common with prospectuses, PDSs are not approved by the regulator.<sup>7</sup> Investment product issuers are also subject to ongoing disclosure and periodic reporting requirements.

Licensees under the consumer credit framework must give consumers a Credit Guide, setting out their services and costs (similar to an FSG). Licensees have to provide key fact sheets for home loans and credit cards, and for credit products must disclose

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<sup>6</sup> Which includes shares, company issued options, finance company debentures, bonds, preference shares and convertible securities.

<sup>7</sup> Although ASIC can issue a stop order when problems with a proposed financial product have been brought to its attention.

key information in a financial table in the contract document, with more limited disclosure requirements in relation to consumer leases.

## Preliminary assessment

### Observation

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

Disclosure is important in the financial system; however, it is not always effective in meeting its objectives.

- Although disclosure can be an effective regulatory tool, it is currently applied in many instances where it may not be the best tool to overcome a particular market problem. For example, disclosure has not been effective in addressing conflicts of interest.
- Despite the range of prescribed disclosure documents provided to retail consumers, many do not easily assimilate information about product information, risks, product features or conflicts. A number of research projects into consumer understanding of disclosure documentation have concluded that documents are long and complex and consumer understanding is poor.<sup>8</sup> In one study, 50 per cent of consumers found the PDS to be too long and over 50 per cent thought there was too much jargon.<sup>9</sup> Effective disclosure documents should enable consumers to easily locate and understand the information they need to make a decision.

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- 8 O’Shea, P 2010, *Simplification of Disclosure Regulation for the Consumer Credit Code: Empirical Research and Redesign – Final Report*, Uniquest, Queensland; Wallis Consulting Group 2008, *Report of Findings of Qualitative Research into Effective Disclosure (Stage II)*; Access Economics 2008, *Factors Affecting the Drafting of Product Disclosure Statements*, Access Economics Pty Limited for the Treasury; Susan Bell Research 2008, *The Provision of Consumer Research Regarding Financial Product Disclosure Documents*, Financial Services Working Group, Forestville, NSW. Note that significant changes have occurred since some of these reports were prepared. Also refer: Ben-Shahar, O and Schneider, C 2014, *More than you wanted to know: The Failure of Mandated Disclosure*, Princeton University Press, Princeton.
- 9 Susan Bell Research 2008, *The Provision of Consumer Research Regarding Financial Product Disclosure Documents*, Financial Services Working Group, Forestville, NSW. Note that some improvements have been made to disclosure documents since this study. A recent study into the sale of consumer credit insurance found that over half of consumers did not read the policy. The consumers who did not read the policy document cited a number of reasons for not doing so, including literacy issues, language barriers, time demands, and the expectation that the document would be long and complex.

Factors that prevent disclosure from enabling informed consumer decision making include:

- **Disengagement** – many consumers are disengaged from their financial affairs and decisions, due to time or motivation, and do not read disclosure documents.
- **Complexity** – disclosure documents are typically long and complex for most consumers. They contain large amounts of information that most consumers consider irrelevant. This makes it difficult for consumers to compare products, understand risks and make informed decisions.<sup>10</sup> However, attempts to make disclosure documents shorter risk the information becoming oversimplified or generalised, which may make consumers overconfident about their understanding of a product and its risks.
- **Consumer behaviour** – research in behavioural economics shows consumers have cognitive biases that can lead to poor financial decisions.<sup>11</sup>
- **Supply-side conflicts and other issues** – disclosure alone is unlikely to correct the effect of broader market structures and conflicts that drive product development or distribution practices, especially where the interests of issuers and distributors are fundamentally misaligned with those of investors.
- **Financial literacy** – many consumers lack the literacy to understand disclosure documents. Evidence has emerged showing deep deficiencies in financial literacy.<sup>12</sup>

Submissions state that disclosure requirements impose significant costs on industry and that industry often takes a compliance mentality to producing disclosure documents. In its submission, Westpac states:

*“[T]raditional disclosure regimes are heavily process-based in terms of both the composition of disclosure information and the dissemination of that information to consumers, because each of these features of the regime are subject to relatively inflexible statutory mandates. This can generate a tick-the-box mentality towards compliance with those mandatory requirements on the part of financial products and services providers”.*<sup>13</sup>

In some areas, the regulatory regime has already moved to address some of the issues raised above with shorter and more focused disclosures. For example, the shorter PDS

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10 Access Economics 2008, *Factors Affecting the Drafting of Product Disclosure Statements*, Access Economics Pty Limited for the Treasury, Canberra.

11 See Australian Securities and Investments Commission (ASIC) 2011, *Report 230: Financial literacy and behavioural change*, Sydney; and UK Financial Conduct Authority (FCA) 2013, *Applying behavioural change at the Financial Conduct Authority*, FCA, London.

12 ANZ 2011, *Survey of Adult Financial Literacy in Australia*, ANZ, Sydney.

13 Westpac 2014, First round submission to the Financial System Inquiry, page 101.

regime mandates tailored, prescriptive disclosure for a limited number of products, including superannuation products, simple managed investment schemes and margin loans.<sup>14</sup> Some submissions argue that the new shorter PDS regime has not resulted in significant consumer benefits to date.

In many areas, regulation has moved away from relying on simple disclosure. The Government has also intervened in some areas of product design and marketing. For example, in the area of superannuation, the Government has mandated detailed design requirements for MySuper products. Other examples include the Insurance Contracts Act and the ban on unfair contract terms.

The design of credit products has been regulated for a considerable time. The previous state and territory Uniform Consumer Credit Code (UCCC) contained prescriptive requirements relating to interest charges and early payout amounts. Recent amendments to the *National Consumer Credit Protection Act 2009* have further regulated the design of reverse mortgages and small amount credit contracts.

Further attempts can be made to improve the effectiveness of disclosure. Alternatively, it may be possible to remove some disclosure requirements where they have proven ineffective and adopt alternative approaches. Such alternatives could include:

- Regulating product features
- Introducing more default product designs, similar to the MySuper default superannuation funds
- Subjecting product issuers to distribution requirements to promote provision of suitable products to consumers
- Giving ASIC product intervention powers

### Policy options for consultation

Submissions suggest that disclosure should only be seen as part of a more flexible framework to inform consumers in their financial decision making.

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<sup>14</sup> The shorter PDS regime for simple managed investment schemes and superannuation products was introduced in the *Corporations Amendment Regulations 2010 (No.5)* following the FSR Refinements Process. See Commonwealth of Australia 2005 *Refinements to Financial Services Regulation: Proposals Paper*, Commonwealth of Australia, Canberra. The margin lending shorter disclosure was introduced as part of the credit reforms in 2010.

### *Improving disclosure*

One approach is to supplement the existing disclosure regime with mechanisms to enhance consumer understanding of product information. Options include:

- **Layered disclosure** – place less reliance on long hard-copy documents and move to make layers of disclosure available to consumers. This could include taking forward the recent changes to mandate hard-copy key facts documents across all product segments, and providing different information at important points in time. Technology can also be used to provide disclosure more effectively at points in time most relevant to the consumer’s need.
- **Better information presentation** – improve disclosure through greater use of shorter disclosure documents, plain English and graphics, and by breaking down complex information to improve consumer understanding. In particular, information about fees and charges, risk profiles, term of product, unusual terms, features or exclusions.
- **Risk profile disclosure** – improve consumers’ ability to understand risk. The recent introduction of the MySuper product dashboard is intended to provide consumers with important information about MySuper products, and for this information to be presented in a standardised manner to allow products to be easily compared, so consumers can make more informed choices.<sup>15</sup>
- **Online comparators and choice engines** – place more reliance on making financial product and service information more accessible to consumers, including information brought together by third-party providers through online tools and comparators. The growth of these services will be facilitated by better access to data, both about financial products and about consumers’ behaviour.<sup>16</sup>

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15 For MySuper products, the dashboard requirements took effect on 31 December 2013 and for Choice investment options (non-default), the dashboard provisions are scheduled to take effect from 1 July 2014. The product dashboard needs to display the level of risk for each product in accordance with a standard risk measure. Risk must be labelled in terms of the anticipated number of years of negative returns for the product over 20 years, with each number corresponding to a risk description that ranges from very low to very high. See Australian Securities and Investments Commission 2013, *Rep 378: Consumer testing of the MySuper product dashboard*, ASIC, Sydney.

16 The UK midata project works with businesses to give consumers better access to electronic personal data that companies hold about them. Midata aims to get more private sector businesses to release personal data to consumers electronically, make sure consumers can access their own data securely, and encourage businesses to develop applications that will help consumers make effective use of their data. See also Thaler, R and Tucker, W 2013, ‘Smarter information, smarter consumers’, *Harvard Business Review*, Jan-Feb, pages 47–54. The trade-off is the risk of imperfect data and embedded assumptions for comparison websites and calculators.

Internationally, governments and regulators are looking at ways that data and choice engines can be used to empower consumer decision making and drive competition.<sup>17</sup>

- **Financial literacy** — many stakeholders have expressed the importance of supporting and implementing financial literacy strategies that may assist consumers to make more informed financial decisions using the information available to them.<sup>18</sup> However, studies are inconclusive about the extent to which financial literacy strategies have been able to improve consumer decision making in relation to financial services. Although the Inquiry considers that financial literacy strategies are important, alone they are not sufficient to ensure adequate consumer outcomes.

### *Regulation of financial product features*

The alternative to supplementing the current disclosure regime is moving towards a more flexible regulatory toolkit. Strategic, targeted regulation of product features may be appropriate in cases where certain features are clearly detrimental to consumers or frequently abused; for example, features that inhibit demand-side competition. Examples of where this approach has been used are banning early exit fees from home loans and introducing caps on interest rates for credit contracts. However, extending product regulation in this way may have the potential to stifle innovation and limit competition. Another option is to implement further measures that shift responsibility for assessing the suitability of products from the consumer to the product issuer. However, any substantial shift in the regulatory regime would require compelling evidence to support it.

### *Default product design*

Another option is to move towards mandated product design, as has happened with MySuper and with credit products under the NCCP Act. The impact of using default products can be substantial, as eight years after Super Choice came into effect,

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17 The type of data that might be used includes data personal to the consumer (for example, patterns of usage) and data relevant to specific products or providers.

18 In Australia, ASIC shares responsibility for implementing the National Financial Literacy Strategy with the business, community, government and education sectors. ASIC's financial literacy work includes providing tools and resources to the general public and specific groups in the Australian community. For example, ASIC's MoneySmart website is an important channel through which ASIC delivers information and tools to consumers. See Australian Securities and Investments Commission 2014, *MoneySmart*, ASIC, Sydney, viewed 24 June 2014, <[www.moneysmart.gov.au](http://www.moneysmart.gov.au)>. However, note that the recent Commission of Audit recommended that ASIC's financial literacy functions should cease.

69 per cent of members were still in a fund they ‘chose’ by default.<sup>19</sup> Superannuation defaults are discussed further in the *Retirement income* chapter.

### *Suitability of financial products*

Product issuers could be subject to more positive obligations with respect to the suitability of their products for retail clients. Credit providers and credit intermediaries are already subject to an obligation that the product be ‘not unsuitable’ for the consumer. Financial advisers are required to comply with a ‘best interests’ test and comply with related obligations. A product issuer could be required to state the particular classes of consumers for whom the product is suitable and for whom the product is unsuitable, and the potential risks of purchasing/investing in the product. Alternatively the issuer could be required to determine that the product is suitable for a particular individual.<sup>20</sup>

### *Product intervention powers*

In the United Kingdom, the regulator has been given a number of temporary product intervention powers to address specific issues.<sup>21</sup> It will also periodically review financial services industry sectors to examine how products are developed and the governance standards in place to ensure fairness to consumers.

ASIC could be given the ability to prescribe the marketing terminology used for complex or more risky products. For example, 2013 ASIC research indicated that consumers often misunderstand the terms ‘capital protected’ and ‘capital guaranteed’. Given capital protected structured products may involve significant potential for investors to lose money due to failure of the guarantor, this labelling may distract consumers from investigating the underlying risks and risk/return profile of the product.<sup>22</sup>

ASIC could also be given the power to ban products or product features. However, the challenge with this type of approach is ensuring regulator accountability. It would

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19 Investment Trends 2013, *Member Sentiment and Communications Report*, June. Note: Based on a survey of 9,607 Australians with superannuation.

20 European Parliament legislative resolution of 15 April 2014 (EU), No 1093/2010 of the European Parliament and of the Council on Markets in Financial Instruments, Article 25 Paragraph 3, states: “Member States shall ensure that where an investment firm provides investment advice recommending a package of services or products bundled pursuant to Article 24(11), the overall bundled package is suitable”.

21 See Financial Services Authority 2013, *The FCA’s use of temporary product intervention rules*, Policy Statement PS13/3, FSA, London.

22 Refer Australian Securities and Investments Commission (ASIC) 2013, *Report 340: ‘Capital protected’ and ‘capital guaranteed’ retail structured products*, ASIC, Sydney and ASIC 2013, *Report 341: Retail investor research into structured ‘capital protected and ‘capital guaranteed’ investments*, Sydney (which both update and supplement ASIC 2010, *Report 201: Review of disclosure for capital protected products and retail structured or derivative products*, ASIC, Sydney).

only be appropriate if the regulator could demonstrate that a significant number of consumers are being caused significant detriment.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Improve the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators.
- Remove disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using technology and electronic delivery.
- Subject product issuers to a range of product design requirements, such as targeted regulation of product features and distribution requirements to promote provision of suitable products to consumers.
- Provide ASIC with additional powers such as:
  - Product intervention powers to prescribe marketing terminology for complex or more risky products.
  - A power to temporarily ban products where there is significant likelihood of detriment to consumers.
- Consider a move towards more default products with simple features and fee structures.

*The Inquiry seeks further information on the following areas:*

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

## Financial advice

Submissions highlight the critical role that financial advice can play for consumers, by providing guidance with financial planning, debt management, insurance and product recommendations. Given mandated superannuation investment, and the fact that increasing numbers of consumers are entering retirement with substantial superannuation investments, as well as the complexity of some financial products, financial advice is becoming increasingly important.

The main issue with financial advice is variability in its quality. In addition, many consumers have difficulty assessing the quality of advice they are receiving and understanding the risks and rewards inherent in particular products. Access to affordable advice for consumers is also an issue, although lower-cost advice still needs to be of reasonable quality to provide a benefit.

## Preliminary assessment

### *Observation*

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

## Regulation of financial advice

Financial advice is regulated under the Corporations Act.<sup>23</sup> Financial advice is defined as a recommendation or statement of opinion intended to influence a consumer's decision. There are two types of financial advice: general and personal. Personal advice is provided if the adviser has (or could reasonably be expected to have) considered a person's objectives, financial situation or needs. All other advice is general advice. Factual information about financial products is not defined as advice. The regulation of financial advice and information is described in Figure 6.2.

Licensed financial advisers are subject to an overall obligation to be "efficient, honest and fair" and to manage conflicts of interest. Licensees must ensure representatives are

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<sup>23</sup> Credit assistance (such as mortgage broking/advice) is covered by the *National Consumer Credit Protection Act 2009*. Responsible lending requires a consideration of the personal circumstances of a borrower to determine the affordability and suitability of a loan. The Inquiry does not propose to discuss credit assistance services such as mortgage broking in this chapter, as submissions have mainly been concerned with issues relating to financial advice.

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adequately trained and competent. Personal advice, general advice and factual information are subject to generic consumer protection provisions, for example those against misleading or deceptive conduct.

Under the Corporations Act, financial advisers are required to have a reasonable basis for personal advice, which includes the requirement that the advice provided is appropriate; and to warn their client if advice is based on incomplete or inaccurate information. The introduction of Future of Financial Advice (FOFA) in 2012 (with mandatory application from mid-2013) has built on these requirements. In particular, it introduced a 'best interests' duty, and a requirement to put the interests of the client ahead of those of the adviser. These provisions have provided greater clarity over the expectations and requirements for financial advisers.

FOFA also introduced a ban on conflicted remuneration for both personal and general advice<sup>24</sup> to align better the interests of financial advisers and consumers. The Government has recently announced amendments to FOFA which, while prohibiting the payment of upfront and trailing commissions for general advice,<sup>25</sup> would allow incentive payments for general advice in situations where the:

- Payment is not a commission
- Person providing general advice is an employee of the product provider
- Person providing general advice has not provided personal advice to any retail client (other than in relation to a basic banking product, a general insurance product or a consumer credit insurance product)
- Product is issued or sold by the product provider

Conflicts of interest have been a longstanding issue in financial advice. There has been a tension between providing financial advice for the benefit of consumers and the product distribution role played by advisers. Shadow shopping studies carried out by ASIC found a strong relationship between advisers giving non-compliant advice and

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24 While the ban has technically commenced, a large portion of the benefits currently being paid would be grandfathered. There are exceptions to the ban on conflicted remuneration in certain circumstances, including benefits relating to basic banking products, general insurance and life risk insurance outside superannuation.

25 In addition to explicitly banning commissions, the Government has flagged that it also intends to put in place a regulation-making power that may prescribe circumstances in which all or part of a benefit is to be treated as conflicted remuneration. See Cormann, M (Minister for Finance and Acting Assistant Treasurer) 2014, The Way Forward on Financial Advice Laws, media release MC 61/14, 20 June, Canberra.

conflicts of interest in business models.<sup>26</sup> ASIC's submission argues that, in recent cases of substantial consumer loss, conflicts of interest held by financial advisers have often been a driver.<sup>27</sup>

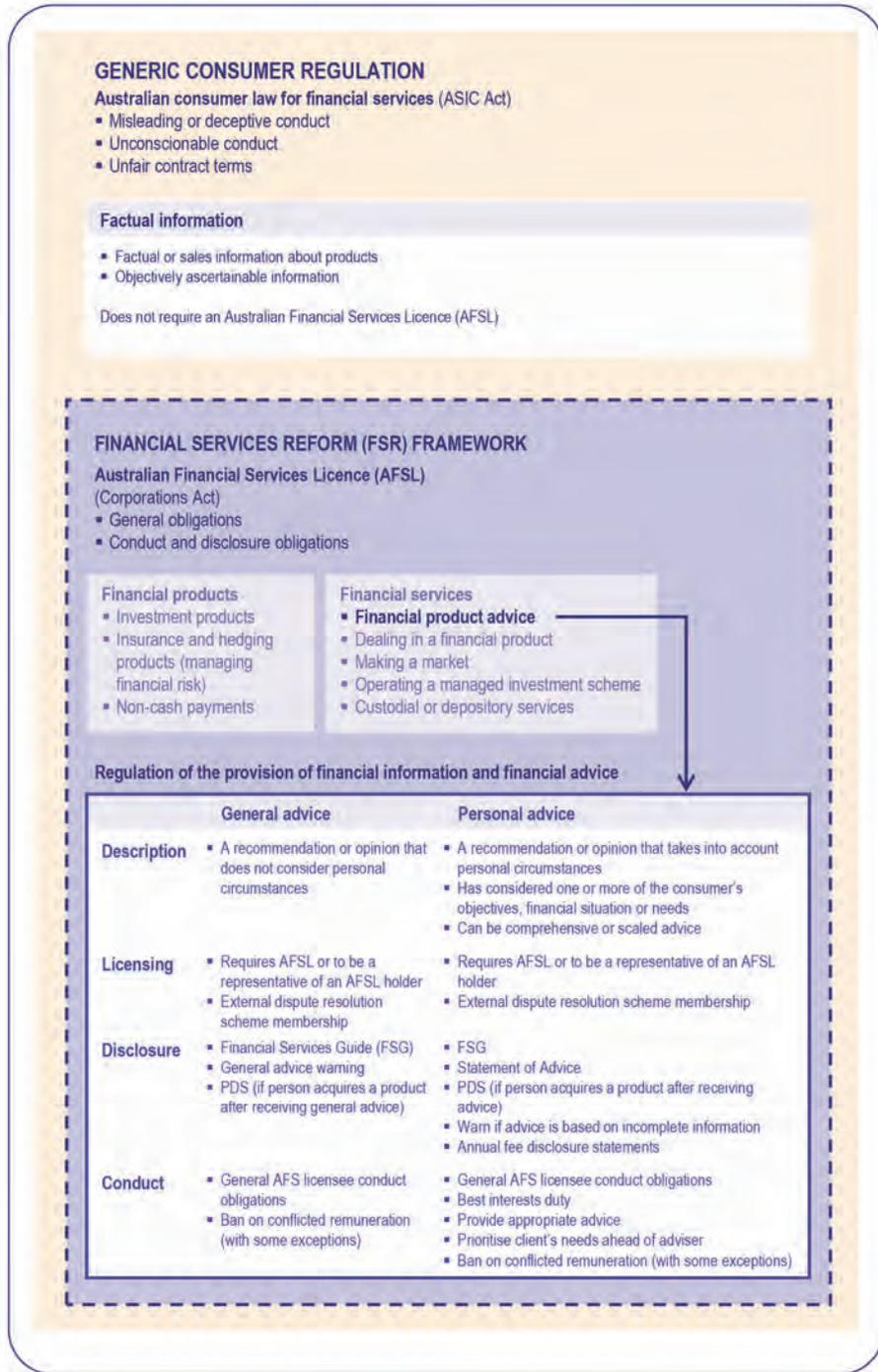
The Inquiry considers the principle of consumers being able to access advice that helps them meet their financial needs is undermined by the existence of conflicted remuneration structures in financial advice.

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<sup>26</sup> Australian Securities and Investments Commission (ASIC) 2011, *Report 251: Review of financial advice industry practice*, ASIC, Sydney, paragraph 43.

<sup>27</sup> Australian Securities and Investments Commission 2014, First round submission to the Financial System Inquiry.

**Figure 6.2: Regulation of the provision of financial information and financial advice**



## Personal advice

The quality of personal advice is an ongoing problem. Personal advice is a recommendation that takes into account personal circumstances. Many submissions state that the quality of advice is variable and ASIC shadow shopping exercises indicate that consumers often receive poor-quality advice.<sup>28</sup> This poor-quality advice mainly relates to two factors, the:

- Relatively low minimum competence requirements that apply to advisers
- Influence of conflicted remuneration arrangements

The price of personal advice has often been hidden by opaque price structures and indirect payments. FOFA has driven a move to fee-for-service structures; however, some consumers are reluctant or unable to pay for financial advice through upfront fees.

## Adviser competence

The competence of advisers varies widely. Some advisers are highly qualified and competent, others less so. Consumers find it difficult to know the difference.<sup>29</sup> Some submissions propose stronger education requirements for advisers, especially for more complex Tier 1 products<sup>30</sup> and for self-managed superannuation funds (SMSFs).<sup>31</sup> Submissions raise a range of options for lifting standards for providing advice, including:

- Strengthening education and training requirements for advisers

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28 Australian Securities and Investments Commission (ASIC) 2011, *Report 251: Review of financial advice industry practice*, Sydney. Australian Securities and Investments Commission 2013, *Report 362: Review of financial advice industry practice: Phase 2*, ASIC, Sydney. Australian Securities and Investments Commission (ASIC) 2013, *Report 337: SMSFs: Improving the quality of advice given to investors*, ASIC, Sydney.

29 See Australian Securities and Investments Commission (ASIC) 2012, *Report 279: Shadow Shopping Study of Retirement Advice*, ASIC, Sydney. Participants in the study rated their advisers and the advice they received highly: 86 per cent of participants felt they had received good-quality advice and 81 per cent said they trusted the advice they received from their adviser 'a lot', despite ASIC concluding that 58 per cent of the advice was 'adequate', 39 per cent of the advice was 'poor' and only 3 per cent was 'good quality' advice.

30 Tier 1 products are all financial products except general insurance products, consumer credit insurance, basic deposit products, non-cash payment products and First Home Saver Account deposit accounts. However, personal sickness and accident insurance are also classed as Tier 1 products.

31 In January 2014, the Government announced that it will consider opportunities to work with industry to enhance the professional standards (including education and training requirements) of financial advisers and improve confidence in the financial services sector. See Senator the Hon Arthur Sinodinos 2014, *Address to South Australia Liberal Party Luncheon*, 31 January, Sydney.

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- Introducing a national exam for advisers
- Introducing a specific training requirement for advisers who advise on SMSFs
- Introducing an enhanced national public register of advisers, including employee advisers
- Enhancing ASIC's power to include banning individuals from managing a financial services business

### *Strengthening education and training requirements*

ASIC has proposed lifting the current minimum educational requirements set out in *ASIC Regulatory Guide 146: Licensing: Training of financial product advisers*.<sup>32</sup> This view has been supported by the Financial Planners Association, which set out a goal of all advisers having tertiary qualifications as part of ongoing efforts to professionalise the industry. Another alternative is to recognise higher educational standards by introducing concepts such as an 'accredited adviser'.

### *National exam*

ASIC has proposed introducing a national exam for financial advisers.<sup>33</sup> Many other jurisdictions have national examinations; for example, Canada, Hong Kong SAR, Singapore, the United Kingdom and the United States. The risk of introducing a national exam is that consumers may place too much expectation on the regulator guaranteeing the competence of advisers who have successfully passed the exam.

### *SMSF training requirement*

Stakeholders have raised concerns about the adequacy of advice in relation to SMSFs, in particular that some consumers are advised to establish SMSFs where it is not cost-effective and appropriate for their needs. Financial advice competency standards for SMSFs, and other specialised products, could be lifted by requiring specific training or qualifications for advisers giving advice on particularly complex products or arrangements. SMSFs are discussed in further detail in the *Superannuation* chapter.

### *Enhanced national register*

Currently, authorised representatives of licensees must be registered with ASIC; however, there is no obligation for employee representatives to be registered. In its submission, ASIC argues that an enhanced register of financial advisers, including

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<sup>32</sup> See Australian Securities and Investments Commission (ASIC) 2013, *Consultation Paper 212: Licensing: Training of financial product advisers – Update to RG 146*, ASIC, Sydney.

<sup>33</sup> Australian Securities and Investments Commission (ASIC) 2011, *Consultation Paper 153: Licensing: Assessment and professional development framework for financial advisers*, ASIC, Sydney.

their employees, would help raise competence standards in the industry by providing transparency about an adviser's qualifications and employment history. It may also help address the issue of disreputable advisers moving between firms and increase consumer confidence and trust in the sector.

### *Banning individuals from management*

Currently, ASIC has powers to cancel an AFSL or credit licence and ban persons from providing financial services or engaging in credit activities. However, ASIC cannot prevent a person from managing a financial services or credit business. ASIC submits that the combination of an employee register, together with the power to ban a person from managing a financial services business, would assist it to locate and remove advisers who do not comply with legal requirements.

#### *The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Raise minimum education and competency standards for personal advice (including particular standards for more complex products or structures, such as SMSFs) and introduce a national examination for financial advisers providing personal advice.
- Introduce an enhanced public register of financial advisers (including employee advisers) which includes a record of each adviser's credentials and current status in the industry, managed either by Government or industry.
- Enhance ASIC's power to include banning individuals from managing a financial services business.

### Accessibility

Access to quality financial advice helps consumers make informed financial decisions; however, the cost of personal financial advice may reduce its accessibility. High-income earners or high net worth individuals are more likely to seek personal financial advice.

Less than 42 per cent of adult Australians have ever used a financial adviser.<sup>34</sup> Life stage and socioeconomic factors are the most consistent factors determining whether people use financial advisers. Individuals earning over \$150,000 per annum are two

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<sup>34</sup> Roy Morgan Research 2012, data provided to Financial System Inquiry, 18 June 2014.

and a half times more likely to be receiving advice than those earning under this amount.<sup>35</sup> ASIC argues a range of reasons for consumers not seeking advice, including financial literacy, perceptions that advice is out of reach, lack of trust in financial advisers, not wanting comprehensive advice and lack of availability of scaled advice, lack of access to general advice and information, and the cost of advice.<sup>36</sup>

It is challenging to increase the quality of advice and make it more affordable and accessible. The cost of regulation and compliance will ultimately be passed on to consumers. Further, higher education and training requirements may make advice less available, rendering it more expensive and encouraging existing advisers to leave the industry rather than upgrade their qualifications. As a result, some individuals may no longer be able to afford financial advice.

In the absence of quality financial advice, consumers may make inappropriate investment decisions, or fail to make appropriate financial planning decisions. According to Investment Trends, 49 per cent of consumers surveyed say that they have unmet advice needs that they would pay to fill. Of the consumers with unmet advice needs, 42 per cent say they would like advice on retirement planning or transition to retirement.<sup>37</sup> However, consumers are also looking for lower-cost options, including limited or scaled advice on particular issues. A third of consumers would prefer to receive scaled advice, either face-to-face, by phone or online, when cost is factored in, as shown in Table 6.1.

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35 Blackrock 2013, *Investor Pulse Survey*, quoted in Industry Super Australia 2014, submission to Senate Economics Legislation Committee, Inquiry into the *Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014*, pages 8–9. Further, around 42 per cent of people who contacted a financial adviser/planner in the last 12 months were in the top 20 per cent of people based on the value of wealth management products (including superannuation). (Roy Morgan Research 2014, data provided to Financial System Inquiry, 18 June 2014.)

36 Australian Securities and Investments Commission 2014, First round submission to the Financial System Inquiry, paragraph 720.

37 Investment Trends 2013, *Advice Report*, September. Note: Based on a survey of 5,412 adults.

**Table 6.1: How consumers prefer to receive advice**

Preferred method of advice (when cost is recognised as a factor)	Cost	Percentage of consumers who prefer this
Willing to pay for advice		
Scaled advice – phone and online	Low	19%
Scaled advice – face to face	Medium	14%
Comprehensive advice – phone	Medium	11%
Comprehensive advice – face to face	High	7%
Not willing to pay for advice		
Can't afford advice	-	21%
Do it myself	-	27%

Source: Investment Trends September 2013 Advice Report, based on a survey of 5,412 Australian adults.<sup>38</sup>

To make advice more accessible to consumers, one approach may be for advisers to provide more cost-effective scaled or limited personal advice. Scaled or limited advice is personal advice on a single topic or that is not intended to be comprehensive. This can be provided at lower cost. Many consumers only need personal advice at key stages in their life; in many cases, consumers may prefer scaled or limited advice that deals with particular issues.

However, scaled advice may raise issues about the extent of assessment of an individual's circumstances required to receive appropriate and quality advice. The FOFA reforms were intended to facilitate access to quality scaled financial advice; in addition, the Government has recently announced changes to enhance this objective.<sup>39</sup>

Technology, including automation and 'mass customisation' techniques, provides an opportunity to offer consumers more cost-effective advice. It may also enable new business models, such as scaled or automated online advice. Although regulations do not impede the provision of online or automated advice, providing personal advice requires a sufficient process to allow the consumer's relevant circumstances to be taken into account. Otherwise, it may not lead to advice that adequately reflects the consumer's relevant circumstances.

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<sup>38</sup> Investment Trends 2013, *Advice Report*, September. Note: Based on a survey of 5,412 adults. Participants were asked to state how they would prefer to be advised, recognising that cost was a factor.

<sup>39</sup> See Cormann, M (Minister for Finance and Acting Assistant Treasurer) 2014, *The Way Forward on Financial Advice Laws*, media release MC 61/14, 20 June, Canberra.

*The Inquiry seeks further information on the following areas:*

- What opportunities exist for enhancing consumer access to low-cost, effective advice?
- What opportunities are there for using technology to deliver advice services and what are the regulatory impediments, if any, to those being realised?
- What are the potential costs or risks of this form of financial advice, and what measures could be taken to mitigate any risks?

## Independence

Some submissions argue that lack of structural independence can impair the quality of advice. Others argue it is not ownership but remuneration that creates conflicts that reduce quality.

Currently, approximately 15 per cent of advisers are fully independent (part of a practice with its own AFSL); 29 per cent of advisers are part of a majority independent dealer group<sup>40</sup> (0–49 per cent institutionally owned); whereas, 56 per cent belong to dealer groups that are majority owned by institutions or other wealth managers, or are part of a bank branch network.<sup>41</sup>

The current framework does not require personal advice to be independent. It simply limits who can call themselves independent. Some submissions argue it can be difficult for consumers to know whether an adviser is aligned or independent, and that consumers may not fully appreciate the potential implications for the range of products they are offered. The United Kingdom has recently gone further than Australia in dealing with conflicts by labelling these advisers as ‘restricted’ rather than ‘independent’, although restricted advisers are subject to the same professional standards as their independent counterparts.

There have been notable instances of losses incurred by the customers of financial advisers from both independent and aligned groups.

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<sup>40</sup> Use of ‘independent’ in this study does not equate to the definition of independent in the *Corporations Act 2001*.

<sup>41</sup> Investment Trends 2014, *Planner Business Model Report*, May. Note: Based on a survey of 1,038 financial planners. The survey question asks planners which dealer group they belong to. One of the options is ‘Own AFSL’ – which means they are not part of a dealer group (or their practice is not part of a dealer group).

*The Inquiry seeks further information on the following areas:*

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

### General advice

Some intermediaries only provide general financial advice, some only provide personal financial advice, and others provide both. General advice also covers a broad range of conduct, such as media commentary, analyst reports, internet comparison sites and aggregators, opinions by credit rating agencies and advertising by product issuers. In some cases, the boundary between personal and general advice may be difficult to draw.

One issue with general advice is whether it is properly labelled. Some submissions argue that some of the conduct currently regulated as general advice could more accurately be described as sales information, advertising or guidance. The aim of this relabelling would be to give consumers a clearer indication of what is involved. The general advice model encompasses recommendations made in general terms, but may nonetheless be persuasive to individual consumers, depending on their personal circumstances and the trust they put in the entity providing the recommendation.

Issues around labelling different types of advice were raised in the Senate Economics Legislation Committee's report on the Government's Bill to amend FOFA.<sup>42</sup> The report recommended that further consideration be given to distinguishing the meaning of terms such as information, general advice and personal advice.

Some submissions question whether general advice is currently over-regulated or appropriately regulated, given the nature of general advice and the approach of many other countries. Other submissions argue that the risks to consumers from poor sales practices for financial products are sufficiently large that all financial product selling should be regulated. Further, consumers place a high degree of reliance on financial product issuers when making decisions. In 2006, the Government considered a

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<sup>42</sup> Senate Economics Legislation Committee June 2014, *Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014 [Provisions]*, Canberra.

proposal to exempt sales conduct from licensing. However, this proposal was rejected due to concerns that consumers may not understand the difference between sales and advice (even with a disclaimer). The Inquiry does not consider there is a case to further pursue options of this nature.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options:*

- No change to current arrangements
- Rename general advice as ‘sales’ or ‘product information’ and mandate that the term ‘advice’ can only be used in relation to personal advice.

## Other significant consumer issues

### Underinsurance

It is important that consumers have access to products that help them meet their financial needs, including managing their risk. General insurance assists consumers to protect their assets and provides a safety net in the event of loss. Life insurance and income protection insurance help protect consumers and their dependants if they are unable to earn an income, whether due to death, critical illness, or temporary or permanent disablement.

The decision to insure is a personal choice, meaning there will always be a level of non-insurance or underinsurance. However, insurance can mitigate the risk of significant loss and financial hardship for consumers. In addition to the negative effect of non-insurance or underinsurance on the consumer where they suffer loss, costs can be passed on to Government and the non-government organisation sector, particularly in the case of natural disasters.

More granular risk-based pricing of insurance may make it less affordable for some, but can also play an important risk-mitigation role, providing incentives for consumers to implement measures that reduce their risk.

## Preliminary assessment

### *Observation*

Technological developments have the potential to reduce insurance pooling. This will reduce premiums for some consumers; however others will face increased premiums, or be excluded from access to insurance. Underinsurance may occur for a number of reasons including personal choice, behavioural biases, affordability, and lack of adequate information or advice on the level of insurance needed.

Submissions have raised the issue of underinsurance in both the general and life insurance sectors. A number of industry submissions raise the issue of affordability, with a focus on the affordability of flood and cyclone cover for those in high-risk locations. Many consumer group submissions focus on availability and affordability for particular segments.

### *General insurance*

Because underinsurance often only becomes apparent after a loss, and often in a large-scale natural disaster, it is difficult to measure the exact level of underinsurance. One difficulty in measuring underinsurance is that, following a natural disaster, building costs often rise, meaning that a consumer who was adequately insured in normal circumstances may become underinsured in a subsequent natural disaster situation.

In 2013, Quantum Market Research estimated that only 4 per cent of homeowners do not have building insurance, but that 63 per cent of renters do not have contents insurance. However, Quantum also estimated that 83 per cent of homeowners and renters view that they would be worse off in a total loss situation.<sup>43</sup> This non-insurance or underinsurance may be due to one or more of four issues:

1. A lack of understanding about the amount of cover required. In most cases, buildings and contents are insured according to the consumer's evaluations. Further, consumers do not regularly update their sum insured to cover increasing value or new items.

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<sup>43</sup> Quantum Market Research October 2013, *The Understand Insurance Research Report*, Melbourne. See also Australian Securities and Investments Commission (ASIC) 2005, *Report 54: Getting Insurance Right, A Report on Home Building Underinsurance*, ASIC, Sydney, where it was estimated that structures destroyed by the Canberra bushfires were underinsured by an average of between 27 and 40 percent of the building cost.

2. Deliberate self-insuring for the whole or only a proportion of the value, sometimes driven by a desire for lower premiums.<sup>44</sup> Alternatively, consumers may not see value in holding insurance, because they have few valuables to insure, they are not risk averse or they are sufficiently wealthy that a potential loss would not be significant.
3. A lack of affordability of suitable cover. People may not insure due to the high cost of insurance relative to their financial circumstances.<sup>45</sup>
4. Behavioural factors, which may influence consumers' decision to insure, or the extent to which they adequately insure.<sup>46</sup>

On the issue of affordability, the overall cost of comprehensive motor vehicle insurance and home contents insurance has remained broadly static as a proportion of annual income since 1997. However, the cost of home building insurance has increased significantly since 2008 (Chart 6.1). This reflects the increasing incidence of natural disasters and greater number of claims insurers have incurred as a result (Chart 6.2).

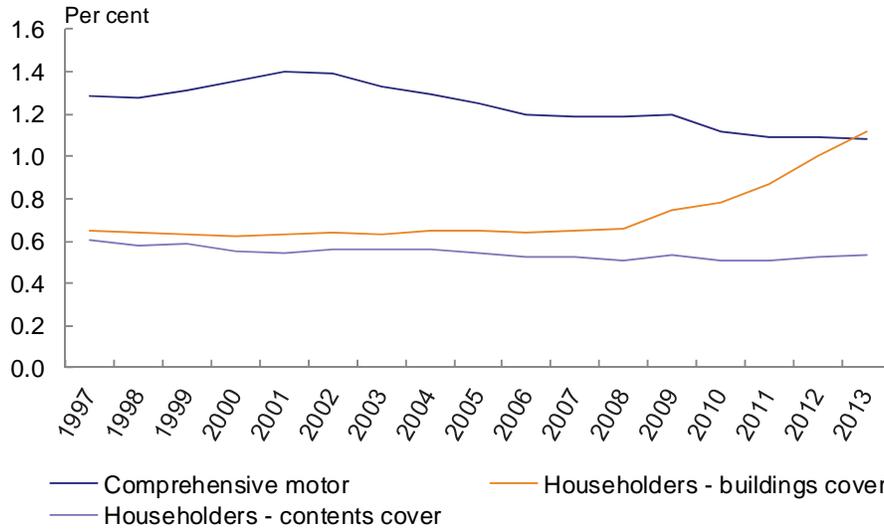
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44 Of those who estimated their own building insurance level, 10 per cent deliberately underestimated the value to lower their premium. For contents insurance, the same figure is 9 per cent. See Quantum Market Research October 2013, *The Understand Insurance Research Report*, Melbourne.

45 Insurance Council of Australia 2007, *The Non-Insured: Who, Why and Trends*, report prepared by Tooth R, and Barker G, Sydney. This report reflects that people may also not insure because consumers find purchasing insurance a significant administrative burden. This is supported by the fact that consumers are more likely to take out contents insurance once they take out building insurance.

46 Consumers have a tendency to focus on short time horizons when comparing upfront costs which impact on low-probability, high-consequence events. For example, consumers may not buy flood insurance as they perceive the risk of damage as being extremely low. See Wharton Center for Risk Management and Decision Processes 2013, 'Informed Decisions on Catastrophe Risk: Insurance and Behavioural Economics, Improving Decisions in the Most Misunderstood Industry', *Issue Brief*, Winter 2013, University of Pennsylvania, Philadelphia.

**Chart 6.1: Insurance cost as a proportion of annual income**

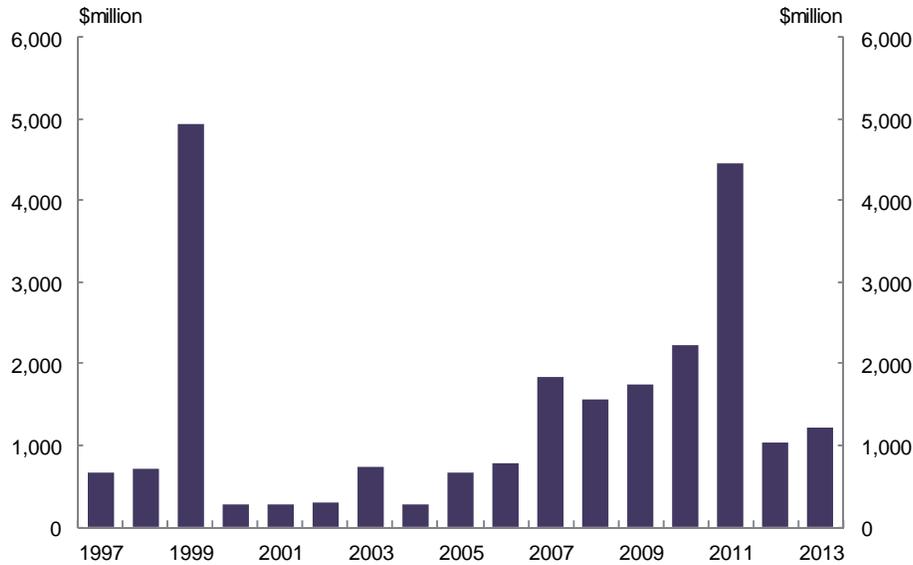


Source: Insurance Statistics Australia, ABS Catalogue 6302.0: Average Weekly Earnings.<sup>47</sup>

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<sup>47</sup> Insurance Statistics Australia is a membership organisation for a number of insurers and has collected and disseminated statistics since 1994. The membership comprises the majority of the Australian market. The average premium per policy for domestic motor, home buildings and home contents is determined from the data provided. It is then normalised by Average Weekly Earnings as published by the ABS.

**Chart 6.2: Cost of claims due to catastrophes (2013 values)**



Source: ICA and Risk Frontiers.<sup>48</sup>

Submissions argue that insurance affordability is a problem for low-income consumers, who require low-value insurance, such as contents insurance of \$10,000. These types of policies are proportionately more expensive, because there are fixed costs that do not decrease in proportion to the policy’s value. The second area of concern is locations with a high risk of natural disasters such as floods or cyclones. Submissions also raise concerns about the impact of state taxes that apply to insurance, raising the cost of insurance premiums.<sup>49</sup>

### *Life insurance*

Superannuation funds now play an important role in providing life insurance to members through group insurance policies. Latest estimates indicate more than 90 per cent of the working age population now has some life insurance.<sup>50</sup> Introducing default insurance into many superannuation funds has extended the number of people

48 The Insurance Council collates from its members the cost of claims from declared catastrophe events. Risk Frontiers (part of Macquarie University) developed an index to bring the costs to current values based on changes in building density and building costs.

49 Refer also to the Australian Financial Centre Forum 2009, *Australia as a Financial Centre: Building on our Strengths*, Canberra; Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, 1999; and Commonwealth of Australia 2009, *Australia’s Future Tax System Review: Report to the Treasurer*, Canberra.

50 Rice Warner 2013, *Underinsurance in Australia*, Rice Warner, Sydney. This refers to life risk only. The report also estimates that 68 per cent of the working age population holds lump sum disability insurance.

holding life insurance; however, submissions question the adequacy of this coverage. Some submissions put forward the view that underinsurance for life and disability is significant, requiring policy measures to close the ‘underinsurance gap’. Rice Warner estimates that current life insurance cover is 64 per cent of the amount needed, with disability insurance much lower again.<sup>51</sup>

### *Risk-based pricing*

Submissions argue that underinsurance and non-insurance are likely to become more acute as insurers use data and technology to price individual risk more accurately. Increased risk-based pricing has the potential to advantage some consumers by reducing costs, but disadvantage others through increasing costs – potentially to the point of unaffordability. In addition, increased risk-based pricing may mean some consumers are not offered insurance at all. This issue arose in relation to riverine flood insurance following the 2011 Brisbane floods, with residents of flood-prone areas experiencing significantly higher premiums for cover, or finding none available.<sup>52</sup>

The trend towards individualised risk-based pricing is growing, as firms access larger data sets, including data from outside their own businesses, and develop more sophisticated analytical techniques. For example, the Insurance Australia Group now prices at the household or address level for personal building, home and contents insurance for flood and cyclone risk. Its NRMA brand also prices at the household level for risks such as theft and domestic house fires.<sup>53</sup> Product issuers who fail to use better information to differentiate risk will be exposed to adverse selection. They will be more likely to acquire higher risks, while more sophisticated competitors will attract lower risks at lower prices.

Governments sometimes limit the use of certain types of information for pricing and access decisions.<sup>54</sup> In Australia, some protections exist in the form of anti-discrimination legislation, but usually with an exemption for insurance decisions based on actuarial or statistical data. The Financial Services Council standard on genetic testing, which has been in place since 2002, states that an insurer must not request genetic testing, but can access testing that has already been done.

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51 As income protection insurance is only available to a limited range of people in certain types of employment, it is not possible to judge the level of underinsurance.

52 However, 93 per cent of all home building and/or contents policies now have flood cover as a standard feature. See Insurance Council of Australia (ICA) 2013, *Aggregated Flood Policy Data*, ICA, Sydney.

53 Insurance Australia Group 2014, First round submission to the Financial System Inquiry.

54 In 2009, the US Federal Genetic Information Nondiscrimination Act was implemented to provide protection from genetic discrimination in health insurance. In 2011, the European Court of Justice prohibited gender-based discrimination. Consequently, the cost of UK comprehensive car insurance for first-time female drivers increased by 104 per cent but fell 27 per cent for their male counterparts. See Insurance Australia Group 2014, First round submission to Financial System Inquiry.

Price signals are important in influencing people's decisions about risky behaviour, such as whether to live in a location prone to cyclone, bushfire or flood, or whether to buy a particular car. Price signals may also be beneficial for efficiency and competition. Future developments, such as vehicle telematics, mean that technology and premium prices may directly influence behaviour and reduce the level of risk to the community.

Accessibility can be improved if insurers and lenders better understand the risks involved, especially where the risk is found to be less than previously assumed. However, the better understanding of risk can cause problems for people who are found to be a higher risk. They may face higher premiums or a loss of access. This is a particular problem where consumers are not able to change their risk profile or find it difficult to do so.

### Policy options for consultation

The information available on the extent of underinsurance is limited, including no agreed measure of what level of insurance is desirable. Further evidence beyond that already in submissions would be welcomed.

#### *The Inquiry seeks further information on the following areas:*

- Does Australia have a problem with underinsurance that warrants some form of policy response? Specifically:
  - How does Australia compare internationally on adequacy of insurance coverage?
  - Has the issue of underinsurance been increasing over time?
  - What evidence and data are available to support a conclusion about our level of underinsurance?
  - What evidence and data are available to assess whether more granular risk-based pricing will lead to exclusion or further underinsurance?
- If warranted, what are possible approaches to lessen the existence of, or mitigate the impact of, underinsurance?

### Access to credit

#### Low-income consumers

Submissions raise issues with access to fair and affordable credit for some consumer segments. Consumers require access to products and services that help them meet

their individual financial needs, including credit products, which can smooth consumption. Low-income consumers, consumers with low financial literacy and those precluded from obtaining mainstream credit often use small amount loans to meet everyday expenses.

Submissions contend that such consumers are frequently unable to access suitable credit from mainstream lenders, as they do not meet the eligibility criteria. Instead, they use high-cost products, such as consumer leases, which are regulated differently to credit contracts under the NCCP Act. Or they rely on ‘fringe’ credit providers, such as payday lenders, where they may enter into loans on a recurring basis without being able to use the credit to improve their financial position.

Although lenders will make lending decisions on risk-based criteria and other commercial considerations, access to reasonably-priced small amount credit may have individual and societal benefits. Community organisations and financial institutions are seeking to address this issue with a growing number of joint microfinance initiatives, such as the No Interest Loan Scheme and the StepUP Low Interest Loan.<sup>55</sup> However, these schemes provide a very small supply of reasonably priced fringe credit, compared with overall demand. Outstanding payday loans are currently estimated in excess of \$380 million.<sup>56</sup>

### *Policy options for consideration*

A 2013 report by NAB and the Centre for Social Impact on financial exclusion in Australia<sup>57</sup> concluded the Government should explore ways of scaling up the supply of microfinance products to improve access to credit for low-income consumers. Microfinance initiatives are not-for-profit schemes that provide access to affordable credit for essential goods or savings programs, which aim to help consumers establish positive financial habits. They are designed to address issues of financial exclusion.

Submissions propose that Government and/or industry could facilitate further development of microfinance initiatives, in collaboration with the not-for-profit and community sector, to improve access to small amount credit. This option relies on both the voluntary participation of industry and Government funding. It will likely take

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55 Good Shepherd Microfinance 2013, *An Outcomes Evaluation of the Good Shepherd Microfinance No Interest Loan Scheme (NILS)*, report prepared by Bennett, S. Georgouras, M, Hems, L, Marjolin, A and Wong, J, Centre for Social Impact, University of New South Wales, Sydney. According to the 2014 NILS evaluation, 42 per cent of respondents who had obtained fringe credit in the past stopped or reduced their use of fringe credit due to their NILS loan.

56 Estimated by ASIC based on previous studies into the industry and information from annual reports.

57 Centre for Social Impact for NAB, 2013, *Measuring financial exclusion in Australia*, Centre for Social Impact, Sydney.

time for microfinance initiatives to grow sufficiently to address the needs gap, or they may not be able to grow sufficiently to meet demand in this area.

*The Inquiry seeks further information on the following area:*

Is there a role for Government and/or industry to facilitate further development of microfinance initiatives, in collaboration with the not-for-profit and community sector? To what extent would this improve access to small amount credit?

### Small business borrowing

Banks provide the majority of lending to small business.<sup>58</sup> Access to credit helps small businesses meet their start-up, expansion or ongoing costs and manage their liquidity. Generally, small business lending is more risky than most consumer lending, which mainly consists of low-risk residential loans. This is discussed in the *Funding* chapter.

As a result, when banks lend to small businesses they tightly control lending decisions, providing limited flexibility, and often with detailed and paper-based assessment procedures. Following the GFC, banks have become more selective in determining eligibility. Some banks are reducing their exposure to small- and medium-sized enterprise (SME) borrowers, and lowering loan-to-valuation ratios to reduce their credit exposure.<sup>59</sup>

Yet individual borrowers and small business borrowers often face similar issues.

#### *Preliminary assessment*

Some submissions are concerned about finance for small business, particularly about the restrictive covenants in small business loan contracts. Non-price covenants of loan contracts can make bank loans unattractive to some small businesses. Some submissions label non-price terms on small business loans ‘very restrictive’ and ‘vague’, with concerns that the way some of these terms have been applied has not been transparent. Small businesses are also concerned about the onerous nature of the loan application processes employed by some lenders. To some extent, this can reflect the quantity and quality of information that some small businesses provide to lenders.

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58 RBA data for December 2013 shows the value of outstanding bank business loans for amounts under \$2 million was \$242.5 billion. See Reserve Bank of Australia (RBA) 2013, *Statistical Table D7: Bank Lending to Business – Variable-rate Loans Outstanding by Size and by Interest Rate*, RBA, Sydney. Note: this lending includes an unknown amount of loans provided to businesses that do not fall within the definition of a small business.

59 As observed in Treasury 2010, *Regulatory Impact Statement: Small business credit* (as part of the National Credit Reforms), Canberra.

The regulatory regime that currently applies to credit only regulates credit provided to individuals or strata corporations for personal, domestic or household purposes, or in relation to residential investment. As part of the credit reforms process, a proposal to introduce targeted reforms to small business lending was consulted on in the context of the draft National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill. The Bill proposed mandatory external dispute resolution, product and services cost disclosure by lenders and brokers, and a specific remedy to address practices by some lenders in unfairly refinancing small businesses in financial distress. The reforms were part of the COAG National Partnership Agreement to Deliver a Seamless National Economy. However, the agreement wound up on 30 June 2013, before the reforms were complete and the Bill was never passed.

Similarly, when the unfair contracts provisions now present in the ASIC Act were first announced in 2008, they were initially intended to apply to all standard form contracts, including business-to-business contracts. However, the legislation was restricted to consumer contracts, in response to criticism by the business community that such laws might create uncertainty.

A balance needs to be struck between facilitating access to credit on equitable terms and allowing lenders to effectively manage their risk and price accordingly. Regulating business credit more intensively may reduce access to or the affordability of credit for small business.

The Inquiry notes that Treasury is undertaking a consultation process on behalf of Consumer Affairs Australia and New Zealand on extending unfair contract term protections to small business. A consultation paper was released on 23 May 2014.<sup>60</sup> The Inquiry will continue to monitor this consultation process until the Final Report is issued.

## Consumer loss and compensation

Consumers require access to remedies and redress in the financial system where they may have been subject to misconduct. When investing, some consumers have suffered significant, uncompensated losses when non-prudentially regulated institutions have collapsed and/or where there has been misconduct on the part of financial services providers. A number of collapses have led to significant consumer losses, including Storm Financial, Trio Capital, Opes Prime, Westpoint and Commonwealth Financial Planning. In some cases, consumers received partial compensation; however, a significant proportion of losses remain uncompensated. Although the system is not

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<sup>60</sup> Commonwealth of Australia 2014, *Extending Unfair Contract Term Protections to Small Businesses, Consultation Paper*, Canberra.

designed to eliminate all risk of loss, submissions raise a number of issues relating to consumer loss and compensation, including the:

- Adequacy of the regulatory framework for managed investment schemes
- Appropriateness of compensation mechanisms

### Adequacy of framework

Consumers have experienced significant losses from investing in the managed investment sector, although these losses are small compared to the overall size of the sector. Major sources of loss include failed agricultural schemes, mortgage and direct property schemes, and unlisted mortgage common enterprise schemes.<sup>61</sup> Although some losses reflect poor underlying asset investments, or market price declines, others reflect poor business models, poor advice or fraud.

This raises the issue of whether the framework for regulating managed investment schemes adequately safeguards the rights of investors, especially compared with companies.

In a recent report, the Corporations and Markets Advisory Committee made a range of recommendations and proposals, which included to:

- Change the ‘trustee like’ obligations of responsible entities
- Review the structural requirements of managed investment schemes
- Prohibit common enterprise schemes
- Amend the definition of what can be called a liquid asset
- Clarify what is meant by ‘scheme property’ and how the client money provisions are applied to monies held by responsible entities
- Improve the external administration framework for failed managed investment schemes<sup>62</sup>

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<sup>61</sup> Common enterprise schemes are a kind of managed investment scheme that is generally structured as a series of agreements between the member, the responsible entity and various external parties. The ‘scheme’ in this case is not a pool of assets under management, but rather the common enterprise carried out in accordance with those agreements. See Corporations and Markets Advisory Committee (CAMAC) 2012, *Managed Investment Schemes Report*, CAMAC, Sydney.

<sup>62</sup> Corporations and Markets Advisory Committee (CAMAC) 2012, *Managed Investment Schemes Report*, CAMAC, Sydney and Corporations and Capital Markets Advisory Committee (CAMAC) 2014, *Managed Investment Schemes Discussion Paper: The establishment and operation of managed investment schemes*, CAMAC, Sydney.

### *Policy options for consultation*

Given recent financial collapses, submissions question the adequacy of the regulatory framework for managed investment schemes to protect the interests of their investors.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options:*

- No change to current arrangements.
- Amend the existing regulatory framework for managed investment schemes.

### Compensation arrangements

Overall, stakeholders have said that dispute resolution systems are working well.<sup>63</sup> Despite this, some stakeholders consider that current compensation arrangements may not be adequate to provide redress to consumers who have suffered financial loss. This is evidenced by the Financial Ombudsman Service (FOS) submission, which reports significant unpaid determinations and uncompensated loss. Since 1 January 2010, 19 financial services providers have been unable to comply with 105 determinations exceeding \$8.3 million.<sup>64</sup> According to FOS, the level of unpaid determinations as at 31 December 2013 is approximately 33 per cent of all determinations made in its investments jurisdiction.

Other submissions raise specific issues about the sufficiency of relying on professional indemnity (PI) insurance as a compensation mechanism. Submissions contend that PI insurance fails as a complete compensation mechanism because:

- Where there is significant consumer detriment, aggregate funds available under the policy may be insufficient to meet all claims.
- The policy may not cover conduct giving rise to the compensation.
- The amount of the award may be below the applicable excess under the policy.<sup>65</sup>

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<sup>63</sup> The requirement to have a dispute resolution system applies to AFSL holders and credit licence holders. It also applies to product issuers and product issuers that deal with retail clients but do not require an AFSL for various reasons (for example, a legislative licensing exemption).

<sup>64</sup> Financial Ombudsman Service (FOS) 2014, *Unpaid FOS determinations by financial services providers: An overview*, FOS, Melbourne. Note that the Credit Ombudsman Service Limited has only reported three unpaid determinations, totalling about \$227,000.

<sup>65</sup> Financial Ombudsman Service 2014, First round submission to the Financial System Inquiry, page 22.

### *Policy options for consultation*

Submissions are mixed on the need for any statutory compensation scheme. Some argue that any scheme would increase moral hazard risk and would ultimately come at a cost to consumers. Others argue that a simple capped default compensation scheme should be considered to promote consumer confidence and trust in the financial system.

The Wallis Inquiry recommended against statutory compensation schemes in the financial sector, including deposit insurance. A report released by Richard St John in 2012 also concluded that it would be inappropriate and possibly counterproductive to introduce a last-resort compensation scheme.<sup>66</sup> The report concluded that a better measure would be to reduce the incidence of misconduct and loss in the first place through improved regulator surveillance and stronger PI insurance requirements. The main downside of a statutory compensation scheme is that the better participants in the industry are likely to subsidise other participants, who do not have high standards of compliance and conduct.

Another option, which could proactively reduce loss through misconduct, would be to increase ASIC's resourcing and capability for proactive surveillance of its regulated population. This is discussed in further detail in the *Regulatory architecture* chapter.

#### *The Inquiry seeks further information on the following area:*

Given the limitations of professional indemnity insurance, what options, if any, exist for addressing the issue of consumer loss?

### Product rationalisation of 'legacy products'

A number of submissions raise concerns about the operational risks and costs associated with the ongoing operation of 'legacy products'. These are often managed investment schemes or life insurance products that have become outdated and closed as a result of commercial and legislative changes.

In 2009, industry estimated that up to \$220 billion of funds under management may be in legacy products, adding an industry-wide operational cost of between \$120 million

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<sup>66</sup> Commonwealth of Australia 2012, *Compensation arrangements for consumers of financial services*, prepared by St John, R, Canberra.

and \$350 million per year.<sup>67</sup> These costs represent an inefficiency drag on the funds management sector and, ultimately, a cost passed on to consumers.

Submissions are most concerned about the lack of a practical, cost-effective and consistent product rationalisation regulatory framework to enable the conversion or consolidation of legacy products into products with equivalent features and benefits. This issue creates a trade-off that needs to be balanced between the interests of consumers who hold legacy products and product issuers.

### Policy options for consultation

Government consulted on proposals for a new product rationalisation framework in 2009.<sup>68</sup> The paper also discussed proposals for designing relevant taxation relief where assets are transferred under product rationalisation. These proposals have not been acted on to date. Thus, the operational risks and costs to consumers relating to legacy product operation remain today. The Inquiry considers that taxation relief issues related to product rationalisation should be considered in the Tax White Paper process.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Government to renew consideration of 2009 proposals on product rationalisation of legacy products.

*The Inquiry seeks further information on the following areas:*

- Are there elements of the consumer framework not covered in this chapter that require consideration?
- In addition to the current regulatory framework, what role can industry self-regulation play in improving consumer outcomes generally?

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<sup>67</sup> Treasury 2009, *Product Rationalisation of Managed Investment Schemes and Life Insurance Products, Proposals Paper*, Canberra.

<sup>68</sup> Treasury 2009, *Product Rationalisation of Managed Investment Schemes and Life Insurance Products, Consultation Paper*, Canberra.



## 7: Regulatory architecture

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Australia's current regulatory model has served us well. The global financial crisis (GFC) tested regulatory arrangements globally and domestically, and Australia's twin peaks model has proven robust and effective. A number of overseas jurisdictions have looked to aspects of Australia's model to address weaknesses the GFC exposed in their financial systems.

Submissions have not called for significant change to Australia's regulatory framework. However, both submissions and stakeholder consultations yielded a wide range of suggestions for improving the existing architecture. Based on these views, the Inquiry proposes policy options for consideration and further feedback.

The Inquiry has commissioned work on the costs and benefits of the extent of regulation in the financial system and seeks further evidence in this regard.

The Inquiry also notes that, concurrent with the preparation of this report, the Senate has been examining the performance of the Australian Securities and Investments Commission. The Senate Committee's Report contained a large number of recommendations that are of relevance to the work of this Inquiry. The Senate Report was issued at the time the Interim Report was being finalised for printing. The findings of the Senate Report will be carefully examined by this Inquiry in the lead-up to its Final Report.

Based on evidence to date, the Inquiry observes:

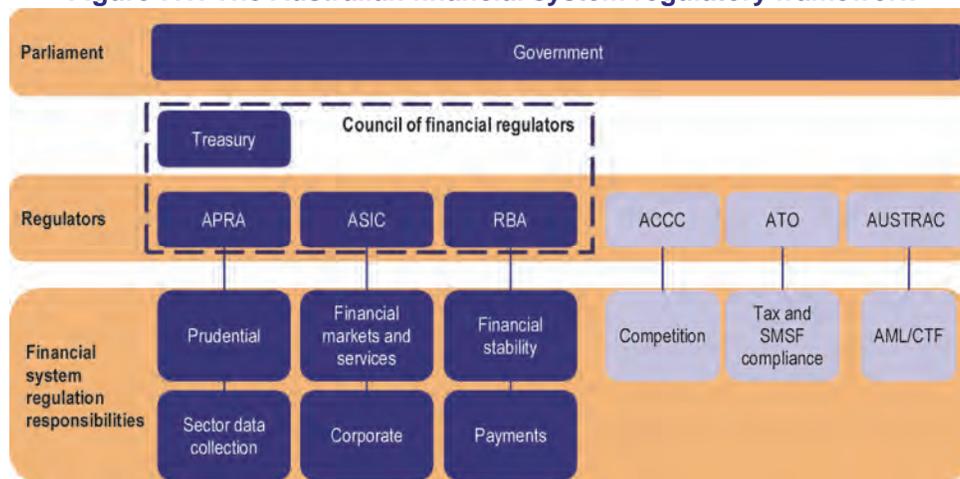
- The regulatory perimeters could be re-examined in a number of areas to ensure each is targeted appropriately and can capture emerging risks.
- Australia generally has strong, well-regarded regulators, but some areas of improvement have been identified to increase independence and accountability.
- During the GFC and beyond, Australia's regulatory coordination mechanisms have been strong, although there may be room to enhance transparency.
- Regulators' mandates and powers are generally well defined and clear; however, more could be done to emphasise competition matters. In addition, ASIC has a broad mandate, and the civil and administrative penalties available to it are comparatively low in relation to comparable peers internationally.
- To be able to perform their roles effectively in accordance with their legislative mandate, regulators need to be able to attract and retain suitably skilled and experienced staff.

## Context

Sound regulation underpins confidence in the system, encourages participation and facilitates efficient allocation of funding and risk in the economy. However, regulation also imposes costs on institutions and the economy more broadly. Regulation should strive to meet its objectives, without placing an undue burden on the regulated population.

Figure 7.1 sets out the current Australian regulatory framework at a high level.

**Figure 7.1: The Australian financial system regulatory framework**



## Prudential regulation

The Wallis Inquiry considered financial safety as fundamental to the sound operation of the economy. Recognising that regulation with a financial safety objective can affect efficiency, competition and innovation, the prudential perimeter was tightly circumscribed – targeted to where the intensity of promise is highest, such as deposits and insurance.

Prudential regulation in Australia applies directly to authorised deposit-taking institutions (ADIs), general insurers, life insurers, and registered superannuation entities and their trustees.

Today, prudential regulation takes a group-wide view. International standards require a group’s financial and operational aspects to be understood and assessed, as well as the individual prudentially regulated entities within them. The largest and most complex groups are expected to have the greatest level of supervisory intensity. A group-wide framework is in place for banking and insurance groups.

## Retail payment systems regulation

The Wallis Inquiry considered the most intense of financial promises are those that provide payment services. At the time, banks were the main providers of payment services and the primary interface with payment systems. The Payments System Board (PSB) was created as a separate board of the Reserve Bank of Australia (RBA) to make decisions related to regulating the payment system. The PSB has a clear objective to ensure stability and confidence in the system, while improving efficiency and competition.

Today, the payments landscape has changed considerably. Cash and cheque transactions have declined significantly and electronic payments have grown strongly. Technology advances and payment product innovation are expected to continue. This is consistent with international experience. It has also resulted in a range of models in different countries to regulate the payments sector.

## Conduct regulation

The Wallis Inquiry considered that financial markets cannot work well unless participants act with integrity and there is adequate disclosure to facilitate informed decisions. Conduct regulation was designed to cover all financial products and services, with the intention of ensuring financial markets are sound, orderly and transparent; users are treated fairly; and markets are free from misleading, manipulative or abusive conduct.

Today, conduct regulation applies to most financial services. The number of financial products has extended through growth in market-based instruments, structural changes in financial markets, and technology and innovation. Products and markets have become more sophisticated and complex, making the application of conduct and disclosure requirements more extensive.

## Regulatory burden

Stakeholders have told the Inquiry that Australia has a strong regulatory framework. However, many stakeholders argue that complying with regulation is costly, the pace of change has increased costs and practices for introducing new regulation could be improved.

Following the GFC, the considerable international policy response included new and strengthened regulation for financial system entities. In this context, a number of submissions are concerned about implementing new regulation.

Other chapters address a number of specific issues relating to the burden of regulation. The main issues raised by stakeholders in the context of this chapter relate to:

- The general need to weigh the costs and benefits of new regulation adequately, the need to look for other solutions before applying regulation, or the possibility that, because these processes are not being applied adequately, Australia is potentially over-regulated.<sup>1</sup>
  - A related concern was a lack of time taken for industry consultation or implementation or, in some cases, inadequate consultation processes more generally.
- Regulation potentially having a disproportionate impact on smaller players.<sup>2</sup>
- Concerns about the impost of foreign regulation and international standards since the GFC, especially prudential regulation, including that it should be implemented with more Government policy input/oversight or that it has not supported Australia's needs.<sup>3,4</sup>
  - Foreign regulation and international standards are discussed in more detail in the *International integration* chapter.
  - An analysis of Australia's prudential regulatory framework is discussed in the *Stability* chapter. Further information is sought on costs of prudential regulation.
- A blurring of the distinction between the role of boards and management, especially through the application of prudential regulation.<sup>5</sup>
  - This issue is discussed in more detail in the *Stability* chapter.
- Blurring of the distinction between prudential and non-prudential regulation, and potential overlap between the Australian Prudential Regulation Authority (APRA) and ASIC.<sup>6</sup>

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1 For example: First round submissions to the Financial System Inquiry by the Australian Bankers' Association, major banks and QBE.

2 Customer Owned Banking Association 2014, First round submission to the Financial System Inquiry, page 53.

3 ANZ 2014, First round submission to the Financial System Inquiry, page 49.

4 Westpac 2014, First round submission to the Financial System Inquiry, page 31.

5 ANZ 2014, First round submission to the Financial System Inquiry, page 49.

6 Treasury 2014, First round submission to the Financial System Inquiry.

- This is considered in the *Regulatory perimeter* section of this chapter.

## Preliminary assessment

### Costs and benefits of regulation

Measuring whether the benefits of regulation outweigh the costs is challenging, since regulation imposes both direct and indirect costs and benefits. Even where respondents express frustration with the costs of regulation in Australia, they acknowledge that the cost of excessive or unnecessary regulation can be difficult to measure.<sup>7</sup> Aside from direct costs incurred by businesses in complying with regulatory change, regulation also has hidden costs.<sup>8</sup> For example, regulatory costs and complexity can create barriers to entry for new participants or innovations.

Benefits can also be difficult to measure. As APRA points out in its submission: “Many of the specific benefits of prudential regulation and supervision, such as lower losses and increased trust within the financial system, are [difficult] to isolate”.<sup>9</sup>

Despite these difficulties, it is essential that the costs and benefits of Government intervention are assessed to the extent possible.<sup>10</sup> Many stakeholders suggest current processes for doing so are inadequate, potentially leading to over-regulation.

Currently, the Inquiry lacks evidence on both the costs and benefits of reforms to support firm conclusions on this issue, although some information is available around costs. The Australian Bankers’ Association (ABA) estimates the four major banks have spent \$1.67 billion on implementation costs for the following projects: Foreign Account Tax Compliance Act (FATCA),<sup>11</sup> Future of Financial Advice (FOFA) law reform, anti-money laundering (AML) from 2005–06, privacy (including credit reporting), e-payments, the Financial Claims Scheme (FCS), over-the-counter (OTC) derivative reforms and National Consumer Credit Protection.

In 2012, the International Monetary Fund (IMF) studied the relative costs and benefits of post-GFC regulatory reform for Europe, the United States and Japan. The report

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7 QBE 2014, First round submission to the Financial System Inquiry.

8 Some organisations provided confidential estimates of the costs of complying with recent regulatory changes to the Inquiry.

9 Australian Prudential Regulation Authority 2014, First round submission to the Financial System Inquiry, page 63.

10 It should be noted that to date the RBA, APRA and ASIC have been fully compliant with Regulatory Impact Statement requirements as set out by the Office of Best Practice Regulation.

11 Note: FATCA is US legislation but must be implemented by Australian companies in certain circumstances. According to the ABA, FATCA contribution to costs is approximately 14 per cent.

found: “the benefits in terms of less frequent and less costly financial crisis would indeed outweigh the costs of regulatory reforms in the long run”.<sup>12</sup> Importantly, the IMF assessment assumed the way regulation was implemented did not create unnecessary costs. However, this assumption is unlikely to hold in practice. Costs and benefits go beyond the content of the regulation: how it is implemented also matters.

Stakeholders suggest that, in some areas, implementation has been poor in cases where otherwise the reform is supported; for example, very short consultation periods.<sup>13</sup>

Stakeholders report the main drivers of the implementation costs include:

- IT system changes
- Staff costs (i.e. employing specialists to implement regulations)
- Legal advice

In addition, implementation costs can be increased by:

- **Poor timing around the start of regulation**, particularly when there are changing or uncertain compliance dates or unrealistic timelines for compliance, or where compliance dates are set for resource-constrained periods. Examples raised by the ABA included implementing AML and the OTC reforms.
- **Poor domestic/ international regulatory coordination**. For example, the ABA highlighted problems around coordination in the OTC reforms.
- **Inadequate consultation processes with industry**, or insufficient weight given to industry information, resulting in higher-cost, less effective regulatory solutions being selected and implemented.
- **Overly prescriptive legislation**, which both adds to cost and complicates delivery, particularly if it makes no allowance for variations in process and systems capability.

To help assess the costs and benefits of regulation more generally, the Inquiry has commissioned further work on the burden of regulation resulting from both domestic and international reforms. As part of the Government’s deregulation process, Treasury is also managing a substantial ‘stocktake’ and analysis of regulation in the Australian financial system.

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12 Elliot, D, Salloy, S and Santos, A 2012, *Assessing the Cost of Financial Regulation*, IMF Working Paper, IMF, page 68.

13 CBA, First round submission to the Financial System Inquiry, page 124.

The World Bank *Doing Business 2014* ranked Australia 11<sup>th</sup> on its 'Ease of Doing Business' category, behind the United Kingdom (10), the United States (4), Hong Kong (2) and Singapore (1). In the 'Getting Credit' category Australia ranked 3<sup>rd</sup>, with the United Kingdom and Malaysia ahead, while in the 'Starting a Business' category it ranked equal 4<sup>th</sup>. Yet, for 'Protecting Investors', Australia ranked much lower – at 68<sup>th</sup>.<sup>14</sup> In that category, the World Bank "measured the strength of minority shareholder protections against directors' misuse of corporate assets for personal gain," and gave Australia a relatively low ranking.<sup>15</sup>

In summary, this source suggests that, compared to the rest of the world, Australia may not have a regulatory burden problem. Conversely, QBE estimates the total cost stemming from over-regulation at an average of over \$100 per policy, or in the range of 10 to 15 per cent.<sup>16</sup>

### Deregulation and improving policy development processes

Concurrent with this Inquiry, the Government has a deregulation process in place that is consistent with many of the suggestions made by submissions. This includes improved guidance for Regulation Impact Statements and a clear policy statement that the default position of policy makers and regulators should be 'no new regulation'.

Further, in March 2014, the Productivity Commission developed a Regulator Audit Framework that could be used for auditing the performance of regulators, in regard to the compliance costs they impose on business and other regulated entities. Based on this report, the Government is preparing a framework for assessing the performance of regulatory agencies, such as ASIC, APRA, the Australian Competition and Consumer Commission (ACCC) and the Australian Taxation Office (ATO). The *International integration* chapter considers options for further process improvement to have regard to international regulation.

As part of the deregulation process, the Government is undertaking a stocktake and audit of all regulation. This will provide a baseline for measuring the Government's

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14 World Bank *Doing Business 2014* accessed at:  
<<http://www.doingbusiness.org/data/exploreeconomies/australia#protecting-investors>>.

15 The indicators used by the World Bank assess "3 dimensions of investor protections: transparency of related-party transactions (extent of disclosure index), liability for self-dealing (extent of director liability index) and shareholders' ability to sue officers and directors for misconduct (ease of shareholder suits index). The data come from a questionnaire administered to corporate and securities lawyers and are based on securities regulations, company laws, civil procedure codes and court rules of evidence. The ranking on the strength of investor protection index is the simple average of the percentile rankings on its component indicators." For further information see:  
<<http://www.doingbusiness.org/methodology/protecting-investors>>.

16 QBE 2014, First round submission to the Financial System Inquiry, page 41.

progress in reducing red tape and assist in identifying useful areas for future reductions.

### Impact on competitive neutrality

As noted, implementing many post-GFC regulations has created substantial costs. Although large institutions have faced the biggest absolute costs, their smaller competitors may face a higher relative burden, particularly where change imposes fixed costs of implementation. Larger firms may also have more capacity to influence the direction of regulatory change.

On the other hand, smaller firms do not generally want to be subject to different regulatory frameworks than their larger competitors if they consider this will change customer preferences or their access to funding. For this reason, concessional licensing regimes or frameworks can be problematic.

This raises the issue of whether Government and regulators need to take more account of the potential implications of regulatory change on competitive neutrality. This applies to both the design of regulation and the volume of regulatory change to which industry segments are subject.

### Volume of regulation

Typically, defining regulation that imposes a burden on industry takes into account any standards, codes, rules, data requirements and guidance material produced by regulators, whether domestic or international.<sup>17</sup> However, some of this material, such as guidance material, helps the regulated population comply with regulation.

The volume of regulation will depend on a range of factors, including the approach of the regulator and, to some extent, the approach taken by the regulated population.

Seeking to address real or perceived gaps in the regulatory regime can lead to increasingly complex or voluminous regulation. Instead, it may be possible to close perceived gaps or improve poor outcomes without necessarily changing the law.

In some instances, regulators may be able to address issues by reducing the overarching volume of rules and regulations placed on industry, but directing more resources towards supervising high-risk participants, taking stronger or more frequent enforcement action, or both. Increasing the intensity of supervision or enhancing

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<sup>17</sup> The Office of Best Practice Regulation defines regulation as “any ‘rule’ endorsed by government where there is an expectation of compliance”. Also see the ABA submission, which defines regulation as ‘all legislation, codes, rules, (prudential) standards and guidance material produced by any government department or agency that imposes limitations on, or otherwise seeks to modify the behaviour of, individuals or companies’.

enforcement may require either additional resources or re-prioritising existing activities.

### Financial system data

Financial system data is useful for policy makers, regulators, industry, academics and others. In conducting the first stage of the Inquiry, data gaps had an impact on the Inquiry's deliberations. For example, there are gaps in data for infrastructure financing and small business lending. On the other hand, stakeholders have told the Inquiry it can be costly and time consuming to provide data and, in some instances, multiple agencies have duplicate requests.

If new data is to be provided to address gaps, it will be important to look for ways to reduce the reporting burden of data that is either not used or is less useful. Changes in data requirements should also weigh the benefits of collecting it against the potential costs of changing systems and processes to comply with new requirements.

### Policy options for consultation

The Inquiry has commissioned further work on the costs and benefits of financial system regulation in Australia and welcomes empirical evidence on this point.

*The Inquiry seeks further information on the following areas:*

- Is there evidence to support conclusions that the regulatory burden is relatively high in Australia when considered against comparable jurisdictions?
- Are there examples where it can be demonstrated that the costs of regulation affecting the financial system are outweighing the benefits?
- Are there examples where a more tailored approach could be taken to regulation; for example, for smaller ADIs?
- Are there regulatory outcomes that could be improved, without adding to the complexity or volume of existing rules?
- Could data collection processes be streamlined?
- If new data is required, is there existing data reporting that could be dropped?
- Instead of collecting new data, could more be made of existing data, including making more of it publicly available?

## Regulatory perimeters

The perimeters of financial sector regulation establish the population regulated within the prudential, conduct<sup>18</sup> and retail payments frameworks. Each framework has unique objectives and, to the extent possible, should be clear and targeted.

Prior to the Wallis Inquiry, financial system regulators supervised by type of financial institution rather than regulatory function. The Wallis Inquiry sought to simplify the structure<sup>19</sup> and redefine perimeters through the concept of ‘intensity of promise’.<sup>20</sup> The RBA retained responsibility for stability of the financial system and for regulating the payments sector via the new PSB.

Today, the Wallis Inquiry’s structure remains; however, it has been adjusted for new and evolving markets, services and products. For example, the development of financial groups has resulted in adjustments to how the frameworks apply. Standards have also been developed under the licensing regime for clearing and settlement systems. Financial market infrastructure (FMI), such as central counterparties and securities settlement systems, is now regulated and overseen under a framework based on international standards.

An illustrative summary of the perimeter for each framework is depicted in Figure 7.2.

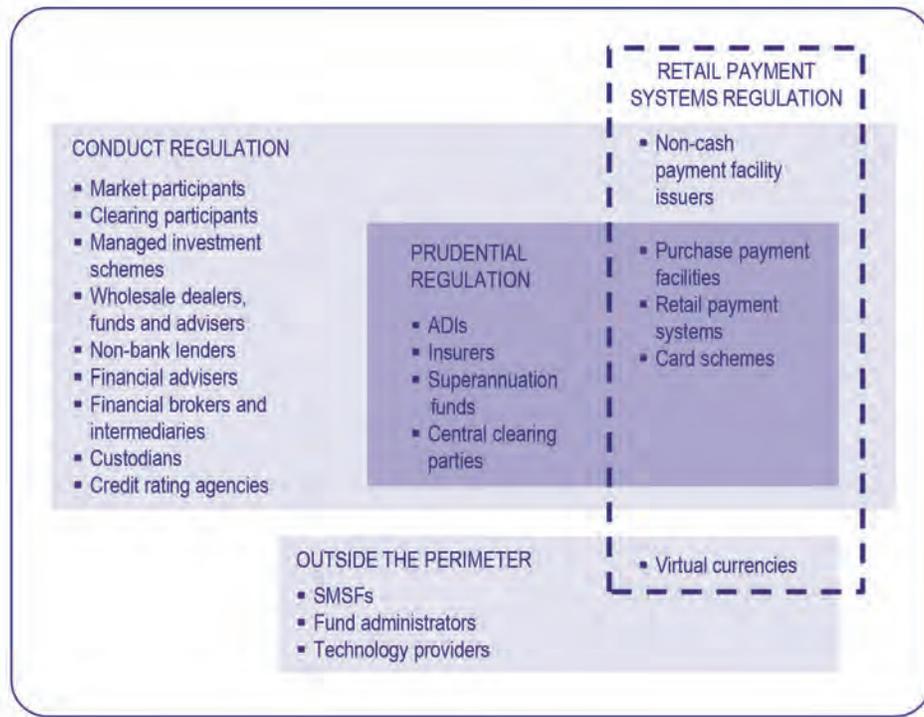
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18 Conduct regulation refers to both regulating markets and the conduct of market participants and other financial product providers.

19 The Wallis Inquiry merged 11 Federal and state regulatory organisations to create APRA, including parts of the RBA responsible for banking regulation.

20 The Wallis Inquiry held that “the higher the intensity of a promise, the stronger the case for regulation to reduce the likelihood of breach”.

**Figure 7.2: Current regulatory perimeters – illustrative summary by institution/activity type**



Market developments and stakeholder consultations suggest re-examining the perimeters for:

- **Prudential regulation** – consider the case for prudential versus conduct regulation of superannuation funds.
- **Retail payment systems** – consider a simplified and/or graduated framework with clear and transparent thresholds.
- **Conduct regulation** – consider the case to extend regulation for fund administrators and technology service providers of sufficient scale and apply select market integrity rules to securities dealers.

### *Observation*

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

## Prudential regulation of superannuation

The growing importance of superannuation has warranted an in-depth treatment in this Inquiry, including re-examining the regulatory framework.

Prudential regulation and supervision has costs, both in terms of direct regulatory costs and costs to efficiency and competition. However, prudential regulation also brings benefits to the economy, as discussed in the *Stability* chapter.

The Wallis Inquiry recognised that superannuation and managed investments were operationally equivalent, but recommended that superannuation's unique characteristics provided a case for prudential regulation: the compulsory nature of some superannuation savings, the lack of choice for a large proportion of members, the mandatory long-term nature of superannuation, and the contribution to superannuation of tax revenue forgone.

In the past 15 years, the superannuation industry has grown and evolved to reach more than \$1.8 trillion in assets under management.<sup>21</sup> Superannuation is now the second largest sector after banking and is continuing to grow rapidly. The wealth management divisions of financial institutions have also grown, resulting in a greater degree of vertical integration. Large financial groups with a material cross-industry presence account for approximately 40 per cent of total superannuation assets.<sup>22</sup> The *Superannuation* chapter provides further detail on this sector.

On the one hand, imposing higher-intensity regulation and supervision comes at a cost, potentially affecting long-term returns to superannuation members. On the other hand, the unique characteristics of superannuation that the Wallis Inquiry recognised have largely persisted. This includes the expectation that superannuation is integral to the retirement income system.

### Preliminary assessment

APRA's prudential regulation of superannuation involves promoting safety and soundness in business behaviour and risk management on the part of trustees and superannuation funds. The primary supervisory focus is on the soundness of the governance arrangements, the competence and effectiveness of the trustee board and senior management, and the risk management and control framework. Where necessary, it also involves remediation and enforcement activities.

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21 Australian Prudential Regulatory Authority (APRA) 2014, *Quarterly Superannuation Performance (interim edition)*, March 2014, APRA, Sydney.

22 Ibid.

Registered managed investment schemes (MISs) and their operators (responsible entities) are regulated by ASIC with similar aims and, in some areas, broadly similar requirements to superannuation entities.<sup>23</sup>

Differences lie predominantly in the intensity of the requirements applying to governance and risk management and the intensity of supervision applied in respect of these standards. Differences also exist in the requirements for financial resources, reserving and liquidity (see Table 7.1).

**Table 7.1: Differences in regulatory requirements for MISs and APRA-regulated superannuation funds**

	Managed investment schemes	APRA-regulated superannuation funds
Financial resources	<p><b>Net tangible assets (NTA) requirement</b> – where scheme property is not held by a custodian, the responsible entity (RE) is required to have a minimum NTA of an amount between \$150,000 and \$5 million or, if greater, 10 per cent of average RE revenue. Where held by a custodian, it is required to have NTA of at least \$10 million, or if higher, 10% of the custodian’s average revenue.</p> <p><b>Cash needs requirement for REs</b> – requirements for projecting cash flows over 12 months</p>	<p><b>Operational risk financial requirement</b> – required reserve against operational risk losses.</p> <p>APRA expects a reserve of at least 0.25 per cent of funds under management to be held by the trustee or APRA-regulated fund. There is some offsetting of this allowed within groups.</p>
Liquidity	<p>REs are able to freeze scheme redemptions in certain circumstances if the scheme becomes illiquid – as occurred during the GFC for some schemes.</p>	<p><b>APRA</b> – regulated funds are required to have a liquidity management plan.</p> <p><b>Legislated portability requirement</b> – funds must meet rollover requests within three days.</p>

Although not directly comparable, the MIS NTA requirements may be higher for smaller entities, whereas the superannuation operational risk requirement is likely to be higher for larger entities. The liquidity management requirements for MISs are not as detailed as those for superannuation, and MIS liquid assets include such assets as

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<sup>23</sup> Some managed investment schemes are not required to be registered with ASIC. For example, schemes with only certain classes of wholesale members.

property. MISs do not have the legislative portability requirements that apply for superannuation and which affect the liquidity needs for superannuation.

Applying prudential regulation to superannuation is likely to impose additional costs. However, low levels of loss in the sector are a significant benefit that may justify or outweigh these costs. In the past decade, there have been lower levels of failure and loss in the prudentially regulated superannuation sector than in the MIS sector. In APRA-regulated superannuation, compensation is available to cover loss arising in cases of fraud, whereas there is no statutory compensation for MISs. Where there has been fraud, superannuation industry-funded compensation has been provided, and where there has been loss due to market movement, members have borne the loss.

The existing regulatory arrangements for superannuation reflect a number of differences between superannuation and MISs. This includes that superannuation is integral to retirement income policy, which is explicitly recognised through taxation incentives, mandatory participation in the system and restricted access prior to retirement.

Some stakeholders argue that prudentially regulating superannuation can lead to members having a greater expectation of Government support, and this can lead to moral hazard for the Government. Another concern is that imposing higher-intensity regulation and supervision comes at a cost, potentially affecting long-term returns to superannuation members. System inefficiencies can also be created by the complexity of having different regulatory arrangements for large financial groups that provide both superannuation and managed investments.

On the other hand, it can be argued that most members are not aware of the regulation that applies to superannuation, and members' expectations of Government support for a failure in superannuation are linked to other characteristics such as its mandatory nature. Low levels of non-market losses in superannuation may offset additional costs of prudential regulation. It can also be argued that higher standards on superannuation trustees are appropriate to address reduced market discipline, potentially arising from the mandatory nature of superannuation. Prudential regulation takes a group-wide view and the high proportion of large financial groups with a material cross-industry presence, means that groups that contain superannuation benefit from consistency in governance and risk management standards and common supervisory practices.

The Inquiry is interested in views on whether there is a strong case for change.

### Policy options for consultation

The Inquiry seeks views on whether the regulation of APRA-regulated superannuation trustees and funds should be aligned with responsible entities and management investment schemes.

With respect to prudential regulation, the Inquiry also seeks views on establishing a mechanism to adjust the prudential perimeter to apply heightened regulatory and supervisory intensity to institutions or activities that pose systemic risks. The *Stability* chapter provides further detail on this option.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Align regulation of APRA-regulated superannuation trustees and funds with responsible entities and registered management investment schemes.

## Retail payment systems regulation

Payment systems regulation has two functions:

1. It seeks to address systemic risk and promote stability, thereby limiting failure and disruption to essential payment services within the financial system. In this case, the focus is primarily on high-value payment systems.
2. It has a focus on competition and efficiency in payment systems. In this case, the focus is on retail payment systems, such as the card systems, where a large number of low-value payments are processed.

Regulatory perimeter issues are more likely to arise in the latter case.

In recent years, market and technological developments have gathered pace in the payments sphere. It is important that regulatory settings are well calibrated to prevent disruption, but also allow for continued innovation.

A number of submissions suggest re-examining the current regulatory framework for retail payment systems, specifically in relation to:

- Simplifying the current framework
- Inconsistent treatment of like products, that may result in an unlevel playing field

## Preliminary assessment

### *Simplify the current framework*

The complex structure of retail payment systems, and the level of public interaction with them, has resulted in the sector's regulation being fragmented. Part of the complexity comes from the fact that regulation needs to be considered separately for:

- The payment *systems* – the rules, infrastructure and arrangements that enable payments to be exchanged; for example, a card payment scheme
- Payment system *participants* – the entities (in most cases financial institutions) that provide the services of a particular payment system to the public; for example, an issuer of credit cards under the rules of a card payment scheme

Submissions, particularly those from non-ADI payment participants, argue that the current regulatory framework is fragmented and unnecessarily complex due to the number of regulators providing oversight of retail payment activities. Although there are a number of regulators, this is not inconsistent with regulation in other areas of the financial system.

The sector is currently subject to regulation by the RBA, APRA, ASIC and Australian Transaction Reports and Analysis Centre (AUSTRAC). Each regulator has its own definitions and concepts relating to payment systems and provides a number of disparate exemptions. See the *Technological innovation* and *Competition* chapters for additional discussion of payments regulation.

### *Unlevel playing field*

Submissions have also raised concerns with an unlevel playing field for providers.

The PSB regulates both retail and wholesale payment systems. The PSB's approach is to encourage industry to undertake reform as required, and it has therefore not licensed and regulated every payment system. Instead, it has designated specific systems where there are concerns with respect to stability, competition or efficiency.

Concerns with regard to an unlevel playing field may also relate to participants that are not supervised by APRA being permitted to participate in a payment system.

One example of potential inconsistent treatment relates to stored value payment systems (purchase payment facilities or PPFs in the Australian legislation), which among other things may include prepaid cards and 'mobile money'. These systems differ from other payment systems because they have a deposit-like element – a function that is the focus of APRA and RBA's regulatory responsibilities, rather than the payment function per se.

In its submission, the RBA supports a closer look at the regulatory status of stored value systems, given that they hold customer funds and there is the potential for increased adoption via mobile devices and e-wallets.

The RBA is also monitoring the development and growth of open-loop virtual currencies in Australia.<sup>24</sup> ASIC considers that virtual currencies are not, of themselves, financial products. However, where payments are enabled in a virtual currency, such as wallet software, these may be financial products. Further consideration should be given to whether these kinds of arrangements should be regulated. Presently, there is considerable divergence internationally in the way virtual currencies are treated for regulatory purposes.

Submissions also raise AML and Know Your Client (KYC) verification as a potential concern. New technologies in payments are also testing the perimeter of AML legislation. With the growth in a range of stored value systems, which could be used to launder money, this may develop into an issue. Strengthening the perimeter for transaction activity is on AUSTRAC's agenda, including ongoing discussions with regulators in other jurisdictions.

### Policy options for consultation

The Inquiry would welcome views on opportunities to simplify or streamline the current regulatory framework.

In establishing a level playing field for retail payment systems and participants, the RBA supports a review of the regulation of PPFs (including stored value payment systems) to provide adequate protection of customer funds. The submission notes that imposing regulation equivalent to ADIs on these players could be onerous, and a graduated framework may be more appropriate.

A graduated framework should consider aligning risk and the scale of activities with compliance requirements. Such a framework could be tiered with clear thresholds for when an activity or participant becomes regulated. Thresholds should take account of the risk posed by unregulated new entrants and new technologies weighed against the costs of imposing regulation and its potential effects on innovation and competition. Regulation should also aim to apply to any payment system or participant in a technology-neutral manner.

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<sup>24</sup> Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 229.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Consider a graduated framework for retail payment system regulation with clear and transparent thresholds.

*The Inquiry seeks further information on the following areas:*

- Is there firm evidence to support opportunities for simplifying the regulatory framework for retail payment systems and participants?
- What are practical and appropriate options to simplify the current regulatory framework for retail payment systems and participants?

## Conduct regulation: fund administrators and technology service providers

There are a number of areas where risks may be developing outside the conduct perimeter, specifically in relation to service providers of scale. Further, market integrity rules do not apply to securities dealers.

### Preliminary assessment

#### *Service providers of scale*

Some service providers outside the regulatory perimeter are of such size and potential influence that service disruption or failure would affect regulated institutions. There are requirements on regulated entities to ensure certain standards. However, with service providers of scale, there may be a case for considering direct regulation. As for all regulation, the costs and benefits of doing so need to be carefully considered to ensure undue burdens are not imposed. Two potential direct regulation cases include administrators and technology service providers of scale.

#### *Administrators of scale*

The provision of fund or investment administration is not currently subject to direct regulatory oversight, although such providers often provide services to regulated

entities.<sup>25</sup> Such administrators are used by trustees of superannuation funds, operators of MISs and investment platforms, investment companies and life companies.

Many administrators service a significant number of funds, including self-managed superannuation funds (SMSFs). The industry is becoming more concentrated, and this trend is expected to continue. If an administrator of scale collapsed, this could cause disruption and loss for members of the superannuation funds and MISs reliant on the administrator.

Requiring an Australian Financial Services Licence (AFSL) for these entities would allow monitoring and minimum standards to be set.

#### *Technology service providers of scale*

A similar concern relates to vendors of IT systems relied on by market participants and financial market operators. If such an IT system failed, this could impede the fair and orderly operation of financial markets.

Technology service providers are subject to limited oversight, as any obligations to have appropriate risk management systems and resources fall on regulated entities, rather than the vendors. With providers of scale, there may be a case for considering direct regulation.

Requiring an AFSL for these entities would allow monitoring and minimum standards to be set.

#### *Securities dealers*

Securities dealers are AFSL holders that provide investor services. These dealers can provide services that are substantially similar to those provided by 'market participants' captured within ASIC's regulatory perimeter. However, ASIC is currently unable to use market integrity-specific remedies to address misconduct by securities dealers, or their clients, in an equivalent manner to market participants. This includes suspicious trade reporting and market manipulation provisions.

#### *Policy options for consultation*

In relation to the conduct perimeter, the Inquiry has identified the following options for consideration:

- Extend AFSL requirements to administrators and technology service providers of scale. Such an option has practical implementation challenges, including setting

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<sup>25</sup> Custodians are subject to AFSL requirements by ASIC, but this does not cover their activities as administrators.

clear and appropriate risk-based criteria to identify appropriate entities without imposing undue burden on all service providers.

- Apply market integrity rules for licensed securities dealers that provide investor services substantially similar to market participants of a licensed financial market.
- Create a mechanism to allow a heightened level of regulatory intensity to be applied where risk arises outside the conduct perimeter. This option also has practical implementation challenges, including setting clear and appropriate criteria for making determinations.

*The Inquiry seeks views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Impose AFSL requirements for providers of fund administration and technology service of sufficient scale.
- Apply market integrity rules for licensed securities dealers that provide investor services substantially similar to market participants of a licensed financial market.
- Introduce a mechanism to allow a heightened level of regulatory intensity to be applied where risk arises outside the conduct perimeter.

## Independence and accountability

### Observation

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

Strong, independent and accountable financial regulators are crucial to the efficient, stable and fair operation of the financial system. Independence is important to ensure supervisory effectiveness, maintain Australia's reputation as a safe and attractive investment environment, and meet relevant international standards.

To this end, independence should be maximised to the greatest extent possible, together with clear and robust accountability mechanisms that provide appropriate checks and balances. Balancing these objectives is challenging.

In practice, the degree of independence and accountability of regulators will not only depend on the legislative and institutional frameworks it will also depend on the culture of the regulatory agencies themselves. Independent regulators need to be equipped to withstand external pressure – both political pressure and undue industry influence. Accountable regulators need to be respectful in the way they discharge their powers and open to questioning, feedback and new ideas or evidence.

Evidence suggests Australian regulators generally are independent from Government. APRA, ASIC and the RBA are established under statute to independently execute their mandate. For example, the APRA Act establishes APRA as an independent statutory authority charged with responsibility for prudential regulation of the financial sector. Thus, in evaluating areas for future improvement, the Inquiry has focused on operational independence and budgetary independence.

## Independence

### Preliminary assessment

#### *Operational independence – ministerial intervention*

The relevant Minister can give a direction to APRA, ASIC and the RBA. For example:

- The Minister has the power to give a direction in writing to APRA or ASIC “about policies [they] should pursue, or priorities [they] should follow”.<sup>26</sup> Ministers cannot give a direction about a particular case, but can direct ASIC to investigate a particular matter.
- The *Reserve Bank Act 1959* allows the Treasurer, with the advice of the Federal Executive Council, to determine the policy the RBA should adopt, if there is a difference of opinion as to whether the monetary and banking policy is “directed to the greatest advantage of the people of Australia”.<sup>27</sup>

Historically, the value governments placed on independence has meant, the ministerial intervention power has only been used in rare and exceptional circumstances. The Inquiry was only able to find one example of its prior use: in 1992, the Attorney-General gave a direction to ASIC’s predecessor body, the Australian

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<sup>26</sup> *Australian Securities and Investments Commission Act 2001*, s 12(1); *Australian Prudential Regulation Authority Act 1998*, s 12(1).

<sup>27</sup> *Reserve Bank Act 1959*, s 11.

Securities Commission (ASC), to require increased cooperative arrangements between the Director of Public Prosecutions and the ASC.<sup>28</sup>

In its 2012 report, the IMF Financial Sector Assessment Program (FSAP) of Australia found that, although such powers have rarely been used, their existence could potentially diminish APRA and ASIC's ability to carry out their supervisory and regulatory functions effectively.<sup>29</sup>

Whether or not the power is explicitly used, its existence can potentially encourage a regulator to follow the wishes of the Minister. This highlights the uneasy balance between accountability to Government and the independence of regulators.

In New Zealand, the Ministerial directions power is less likely to erode regulator independence, as it relates only to broad performance goals, strategies and measures.

The Inquiry seeks further views on whether Ministerial intervention powers erode regulator independence. If the Ministerial direction powers were to be removed or scaled back, additional accountability mechanisms could be introduced, as discussed in the *Accountability* section.

### *Budgetary independence*

A number of principles underpin a best-case funding model for financial regulators:<sup>30</sup>

- **Total funding should be proportionate to the size, complexity and nature of the regulated population.** This aligns regulatory funding to changes in the level of risk in the regulated population.
- **Regulatory costs should be proportionately borne by those contributing to the need for regulation or benefiting from that regulation.** Proportional allocation of regulatory costs promotes the principle of horizontal equity: that market participants should be treated fairly, as outlined in the Australian Government's guidelines on cost recovery models for regulators.
- **Funding should have a high degree of stability and certainty year to year.** This promotes long-term planning and increases efficiencies by avoiding unnecessary short-term costs.

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28 Australian Securities and Investments Commission (ASIC) 2007, *Annual Report, 2006–07*, ASIC, Sydney, page 43.

29 International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF, Washington

30 Oliver Wyman 2012, *Regulatory Funding Models*, data provided to Financial System Inquiry, 22 May. Referencing source: Department of Treasury and Finance 2010, *Cost Recovery Guidelines*, and IOSCO 2010, *Objectives and Principles of Securities Regulation*.

- **Funding should promote operational independence.** This encourages effective and unbiased regulation.

The suitability of the current funding models for ASIC and APRA are assessed below. It is important to note that the Inquiry has not assessed the adequacy of funding currently received by either ASIC or APRA. Rather, the assessment focuses on whether the funding models meet the principles underpinning a best-case funding model.

### ASIC

An assessment against these principles suggests ASIC has a low degree of budgetary independence, with only a weak link between its regulatory functions and the way it is funded.

Like APRA, ASIC's funding level is decided by Government, but funds flow to ASIC from general revenue, rather than an industry-funded levy. Costs for ASIC are borne by the public, in proportion to their tax contributions. Members of the public, as beneficiaries of regulation, do not bear these costs in proportion to that benefit. Equally, market participants, who contribute to the need for regulation, generally do not bear its cost directly.

Furthermore, industry fees are increasingly misaligned with the cost of ASIC performing its regulatory function. Funding is not proportionate to the level of risk in the industry. For example, ASIC notes:

*[It] costs ASIC about \$108 million to regulate AFS licensees; however, ASIC collects ... only \$3.7 million in registry fees from AFS licensees, approximately 3.5% of the cost of regulation.<sup>31</sup>*

ASIC's funding is more variable than APRA's. ASIC's 'core' funding levels have remained relatively stable, with a sufficient degree of certainty through the current new policy proposal (NPP) process. However, special purpose 'non-core' funding, which has a higher degree of uncertainty, has increased in the last few years.

ASIC's submission highlights significant differences between the forward projections of its budget expenditure and realised expenditure. The differences between the forward and realised expenditure constrain ASIC's ability to forward plan in response to market and regulatory developments.

In recent reviews of Australia's financial system and regulatory framework, both the Financial Stability Board (FSB) and the IMF raised concerns about ASIC's lack of stable funding and inability to commit resources to longer-term projects. According to the

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<sup>31</sup> Australian Securities and Investments Commission 2014, First round submission to the Financial System Inquiry, page 52.

IMF, this limited degree of budgetary independence in turn inhibits ASIC's ability to dedicate sufficient resources to conducting proactive supervision. Recent commentary from the IMF and the International Organization of Securities Commissions (IOSCO) generally supports a move towards an industry-funding model.

Globally, most securities and markets regulators are employing industry funding-based models.<sup>32</sup> Adopting an industry-funding model, if designed carefully, may increase the degree of certainty in funding. Despite the advantages of an industry-funding model, a number of potential challenges require consideration. For example:

- Cost of implementation on business.
- Appropriately balancing costs and benefits between industry and the public, where the benefits are seen by some as a public good.
- Method of allocating costs. Using levies gives rise to potential cross-subsidy concerns.

#### **APRA**

APRA's budget is proposed by the APRA members and is determined by the Government as part of its budget deliberations. There is scope to improve the model for determining APRA's funding. Changes to the funding model could increase stability year to year and promote operational independence.

The Government primarily recoups the cost of prudential regulation from annual levies collected from supervised institutions, with a smaller contribution from interest earnings, fees for services and miscellaneous cost recoveries. Stakeholders are concerned about having insufficient time to comment on the Government's annual proposed levies, expressing a desire for more detail on APRA's costs and activities.

#### **Policy options for consideration**

The Inquiry has identified a range of options for addressing the issues discussed above. Views are also sought on maintaining the status quo.

#### ***Move APRA and ASIC to a more autonomous budget and funding process***

##### **Enhance the process for APRA's budget approval**

APRA could be required to publish a comprehensive budget proposal with associated levy proposals and business plans each year, ahead of the Government's annual budget process.

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32 Oliver Wyman 2012, provided to the Financial System Inquiry, 16 June 2014.

The enhanced external consultation process would drive greater internal and external scrutiny of how APRA's resources are allocated across its functions and opportunities for efficiencies. Under this process:

- APRA would publish detailed budget projections for a multi-year period.
- Industry and other stakeholders would receive an opportunity to comment on the budget proposals and the level of APRA resourcing proposed.
- A final budget and levies proposal would then be submitted to Government for approval, including a summary of the comments from stakeholders and APRA's response. Subsequently industry would be levied.

#### **Move ASIC to an industry funding model**

As discussed above, ASIC's predominantly Government-funded model poses limitations in meeting the principles of a best-case funding model. There is a case for moving to an industry-funding model for ASIC, based on approaches taken in the United Kingdom, Canada and other jurisdictions.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Move ASIC and APRA to a more autonomous budget and funding process.

## Accountability

### Preliminary assessment

Australian regulators are subject to similar external accountability arrangements to comparable peer jurisdictions. They are held accountable through a range of mechanisms, including Parliament, courts and tribunals, public media reporting and freedom of information, and reviews by international bodies, such as the IMF FSAP.

The Inquiry recognises that there is room to further strengthen or implement new accountability mechanisms for regulators, particularly in light of proposals to increase independence.

### *Statement of Expectations and Statement of Intent*

The Uhrig Report<sup>33</sup> recommended that Ministers should communicate Government's expectations of statutory authorities, such as regulators, in a public written Statement of Expectations (SOE). Regulators respond to SOEs in a public written Statement of Intent (SOI), which outlines how the authority will meet the Government's expectations.

To date, SOEs issued in Australia do not provide strong guidance on the Government's expectations about either regulatory outcomes to be achieved or risk tolerance. In turn, SOIs do not provide clear metrics or expectations against which regulators intend to measure their performance. Regulators are not required to report against the SOI on a regular basis, so it is difficult to monitor the extent to which expectations are being met.

In contrast, New Zealand's SOIs appear to be one of the principal accountability mechanisms for Crown entities. As such, they clearly articulate how regulators will meet the Government's expectations. The New Zealand SOI process has the added advantage of being regular, systematic and transparent.

Elements that would make Australia's SOEs more effective could include:

- Sufficient detail to address the regulator's full range of responsibilities
- A broad outline of the Government's tolerance for risk in the financial system
- A statement of the strategic direction the Government expects regulators to take

Improving accountability through these mechanisms will require the development of a set of performance metrics that focuses on outcomes.

### *Regulator efficiency*

The efficiency dividend is an important accountability tool that acts as a check on public sector growth. However, it is arguably a blunt instrument that is not well suited to smaller agencies with lower levels of discretionary costs.

Both APRA and ASIC are subject to the 'efficiency dividend' requirements, including 'additional' dividends imposed over and above the standard 1.25 per cent annual dividend. In particular, the imposition of 'additional' dividends increases budget uncertainty and variability for regulators, making it difficult to develop long-term strategic plans.

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33 Uhrig, J 2003, *Review of the Corporate Governance of Statutory Authorities and Office Holders*, Commonwealth of Australia, Canberra.

### *Other issues*

Regulators' activities are overseen by a number of bodies, including the Office of Best Practice Regulation (OBPR) in the Department of Prime Minister and Cabinet, the Auditor-General, and the Ombudsman. However, in general, these bodies are limited in their scope to make regulators accountable because they can only make recommendations, generally to the Minister or the regulator concerned. There may be some scope to bring together the roles of the Government authorities that oversee and ensure the accountability of regulators.

At the same time, external bodies, such as the IMF, focus on the performance of the sector as a whole. This level of oversight does not involve in-depth reviews of the performance, culture and capabilities of individual regulators. Regular, frank and independent assessments of regulators' performance would provide an additional accountability mechanism to industry, Government and the community.

### *Policy options for consultation*

The Inquiry acknowledges policy options need to consider the current accountability mechanisms already in place. Simply imposing new requirements in addition to existing ones is likely to result in some overlap.

The Inquiry has identified a range of options for increasing regulator accountability.<sup>34</sup>

#### *Conduct periodic, legislated independent reviews of the performance and capability of regulators*

These legislated reviews would take account of whether regulators (ASIC, APRA and the PSB) were adequately balancing their respective objectives. The review would assess whether regulators could use their resources more efficiently and effectively. These reviews, performed by independent experts appointed by the Government, would have deep access to assess structural, organisational and cultural issues within the regulator.

Regular reviews would build a strong evidence base for regulator performance, identify areas where capability could be improved and introduce a new accountability mechanism.

#### *Clarify the metrics for assessing regulatory performance*

A set of clear performance metrics for regulators could be a prerequisite for improving the SOE and SOI process. Various metrics may be good long-term indicators of

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<sup>34</sup> We note that the National Commission of Audit and the Productivity Commission have also highlighted a range of mechanisms for assessing regulator behaviour and accountability.

performance, but in the short to medium term may be too strongly impacted by other factors to be reliable indicators of performance.

### *Enhance the role of SOEs and SOIs*

Consideration could be given to removing or modifying the Ministerial directions power, in favour of developing an SOE/SOI process modelled on the New Zealand system. Regulators would be expected to report annually against the Government's expectations set out in the SOE.

### *Additional options*

- Replace the efficiency dividend with tailored budget accountability mechanisms, such as regular audits and reviews to assess the regulators' potential for savings.
  - Conduct regular audits of agency efficiency as a basis for developing, maintaining and reporting against efficiency measures. For example, to assess the potential for savings within the agencies and the level of funding needed.
  - Require regulators to establish and publish appropriate performance and efficiency measures to strengthen accountability. This is consistent with the requirements of the new *Public Governance, Performance and Accountability Act 2013*, which will come into force on 1 July 2014. From 1 July 2015, regulators and other government entities covered by the new legislation will be required to publish an annual corporate plan, covering strategic objectives, strategies to achieve them and an environmental risk assessment.
  - Match growth in expenditure to a relevant index, such as a wage cost index or CPI.<sup>35</sup>
- Stakeholders have raised a number of policy options to improve the process for overseeing financial sector regulators. For example:
  - An Inspector-General of Regulation<sup>36</sup>
  - A unified oversight Government authority for financial regulators, combining the roles of the OBPR, Auditors-General, Ombudsman and other specialist bodies

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<sup>35</sup> Customer Owned Banking Association 2014, First round submission to the Financial System Inquiry, page 58.

<sup>36</sup> Australian Financial Markets Association and Business Council of Australia 2014, First round submissions to the Financial System Inquiry.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Conduct periodic, legislated independent reviews of the performance and capability of regulators.
- Clarify the metrics for assessing regulatory performance.
- Enhance the role of Statements of Expectations and Statements of Intent.
- Replace the efficiency dividend with tailored budget accountability mechanisms, such as regular audits and reviews to assess the regulators' potential for savings.
- Improve the oversight processes of regulators.

## Regulator structure and coordination

Australia's regulatory structure and coordination mechanisms performed well during the GFC, contributing to Australia's strong performance through the crisis. Following the GFC, other jurisdictions have adopted Australia's 'twin peaks' approach, with separate prudential and conduct regulators.

Submissions focused on coordination between the regulators, rather than their individual structures.

## Preliminary assessment

### Regulator cooperation and coordination

#### **Observation**

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

The GFC demonstrated the importance of having strong coordination mechanisms to ensure domestic regulators form a consolidated view of risks in a particular sector and implement coordinated activities. Internationally, there has been a push to increase the coordination and cooperation mechanisms between domestic agencies.

A review of the Australian regulatory landscape highlights a clearly defined mechanism for cooperation and coordination actions between regulatory agencies. Underlying these structures is a culture of cooperation and collegiality.

Based on the issues raised by submissions, the Inquiry's assessment of regulator cooperation and coordination mechanisms has focused on the role, transparency and accountability of the Council of Financial Regulators (CFR). There was a strong sense from submissions that the CFR was the right body for high-level coordination, but that its role could be strengthened.

The Inquiry notes that beyond the CFR, a number of other mechanisms promote effective inter-agency cooperation and coordination on financial sector policy and enforcement issues through, for example, overlapping representation on the agencies' boards and bilateral memoranda of understanding (MOU) between CFR members.

### *Role and responsibilities of CFR*

The CFR provides a forum for the main financial system agencies (i.e. the RBA, APRA, ASIC and Treasury) to facilitate coordination and information exchange on financial sector policy issues. As specified in its Charter, the CFR's ultimate objective is to contribute to the efficiency and effectiveness of financial regulation, by providing a high-level forum for cooperation and collaboration.

The CFR has proven to be a flexible, low-cost approach to coordination.<sup>37</sup> The current structure also provides for frank discussion and collaboration between its members. Importantly, the CFR has no regulatory functions separate from those of its members.

Submissions point to the interactions between the regulatory agencies and Treasury as being inclusive and fostering knowledge transfer, promoting the CFR's effectiveness. The CFR is also recognised internationally as a well-functioning coordination mechanism: the IMF has highlighted that the CFR plays a key role in coordinating financial regulation and stability issues.

However, submissions raise issues with the CFR's membership, transparency and accountability. Some stakeholders recommend the CFR should not be given any additional responsibilities beyond coordination, as this would dilute and blur the responsibilities of individual regulators. The following discussion addresses these points.

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<sup>37</sup> Reserve Bank of Australia and Australian Prudential Regulation Authority 2012, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework*, Australia.

### *Membership*

The Inquiry recognises that the four CFR members do not have direct responsibility to address some objectives relevant to the financial system; for example:

- Anti-competitive behaviour – regulated by the ACCC
- AML and counter-terrorism financing – regulated by AUSTRAC
- Compliance-based regulation of SMSFs – regulated by the ATO

However, broad inter-agency cooperation and coordination mechanisms enable the four CFR member agencies to seek input from other agencies as required. To the extent the CFR members see relevance in doing so, other agencies are invited to participate in Council meetings. For example, the ACCC has been invited to participate on issues relating to contestability and competitiveness.

### *Transparency and accountability*

The CFR has a website with information on how it operates, as well as publications by its members. In addition, many of the issues discussed by the CFR to date are reported on in the RBA's semi-annual Financial Stability Review, with input from other CFR member agencies.

## Policy options for consultation

There are a range of options for potentially increasing the role, transparency and external accountability mechanisms of the CFR. If options were pursued, it would be important that the CFR remained a vehicle for coordination and cooperation, and did not assume powers that appropriately sit with the relevant member agencies.

### *Formalise the role of the CFR within statute*

Some submissions suggest legislating the CFR's powers and functions. On one hand, legislating the CFR would mandate continued inter-agency cooperation if informal collaboration breaks down in the future. On the other hand, the RBA's submission highlights that the CFR is best seen as the collaborative dimension of the regulatory agencies' activities, rather than as a separate body with its own ability to make the regulatory agencies cooperate.

A number of factors should be considered before pursuing this option. In particular:

- Legislation cannot be relied on to promote a culture of cooperation, trust and mutual support between domestic regulatory agencies. These have been highlighted as essential elements of an effective financial stability framework, especially during a crisis.

- If powers were formalised in statute, this could suggest that the regulatory functions are separate from those of its members and could engender confusion as to whether the regulatory agencies' obligations to coordinate arose from their respective charters or that of the CFR.

### Increase CFR membership to include the ACCC, AUSTRAC and the ATO

Some submissions felt consideration could be given to widening the CFR's membership to include other financial sector regulators, such as the ACCC, AUSTRAC and the ATO, who are currently only invited to participate in Council meetings as and when required. Widening its membership would strengthen the Council's ability to perform its role as a coordination body on a whole-of-sector basis.

The effectiveness of the CFR relies on maintaining the clarity of its scope and frankness in discussions. For this purpose, extending its membership to other agencies with much broader mandates may divert its focus.

### Increase the reporting by the CFR

To increase transparency and accountability, the CFR could produce a report each year setting out its activities for the year under review.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Consider increasing the role, transparency and external accountability mechanisms of the CFR:
  - Formalise the role of the CFR within statute.
  - Increase the CFR membership to include the ACCC, AUSTRAC and the ATO.
  - Increase the reporting by the CFR.

## Execution of mandate

A range of factors impact a regulator's ability to execute its mandate, in particular:

- The scope and clarity of the regulator's mandate and powers
- Ability to attract and retain experienced and talented staff

- Sufficient, stable and clear funding, discussed in the *Independence and accountability* section

## Preliminary assessment

### Regulator mandates

#### *Observation*

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

The competition mandates of Australian financial sector regulators compare favourably to international peers. For example:

- APRA's mandate, like that of Canada's prudential regulator, includes an explicit reference to competition. New Zealand refers to competition less directly through efficiency, while the United Kingdom prudential mandate appears solely stability focused.
- ASIC's mandate is similar to peers, with the exception of the United Kingdom Financial Conduct Authority (FCA), which has a specific objective to promote competition.

However, more could be done to strengthen competition considerations through mechanisms other than amending the regulators' mandates.

As a conduct regulator in an advanced, complex economy, ASIC's mandate is broad. The Inquiry seeks views on the breadth of ASIC's mandate and whether this causes or exacerbates challenges for ASIC.

Additionally, gaps in ASIC's powers may reduce its ability to enforce market conduct regulation.

### Balancing objectives: competition

The Inquiry recognises that, although the individual parts of Australia's regulatory mandates are clear, they are not entirely unambiguous. Regulators are required to make judgements in balancing sometimes competing objectives. Submissions typically raise this issue in the context of competition.

Some submissions suggest that, in balancing objectives, APRA tends to prioritise stability above competition. APRA has stated that “the GFC has dispelled any simplistic notion that there is a ‘trade-off’ between financial stability and *sustainable* competition”.<sup>38</sup> Some stakeholders consider that APRA’s mandate should be adjusted to give more weight to competition and competitive neutrality. However, others reject the idea that there is too much focus on stability. For example, APRA’s policy-making process demonstrates its routine consideration of competition issues. Additionally, APRA’s discussion papers and responses to submissions contain references to competition where a proposal may have an effect on competition or where the industry has raised competition concerns in submissions.

Submissions, including from ASIC itself, also argue that ASIC should be given a mandate to promote competition. However, like APRA, ASIC’s mandate with respect to competition is broadly similar to international peers, with the exception of the United Kingdom FCA, which has been given a mandate to promote competition, rather than take account of efficiency.

### Breadth of mandate: ASIC

ASIC’s mandate broadly covers two areas:

1. Financial markets, financial services and corporate regulation
2. Business and company registration

ASIC’s powers and responsibilities in the first area are broadly consistent with financial conduct regulators in other jurisdictions, although most do not have the extent of ASIC’s coverage. Some regulators are moving closer to the ASIC model; for example, the United Kingdom FCA is now taking over responsibility for consumer credit.

ASIC’s responsibilities in the second area are unique compared to conduct regulators overseas.

ASIC’s mandate has grown considerably over the last two decades, generally in response to major reform processes and reviews (see Figure 7.3). In the first instance, the Wallis Inquiry saw significant benefits in having investor and consumer protection within the one agency, especially given the growing inter-linkages between different financial products and services. Subsequent expansions have also been the outcome of policy reforms designed to ensure greater consistency in regulation for both consumers

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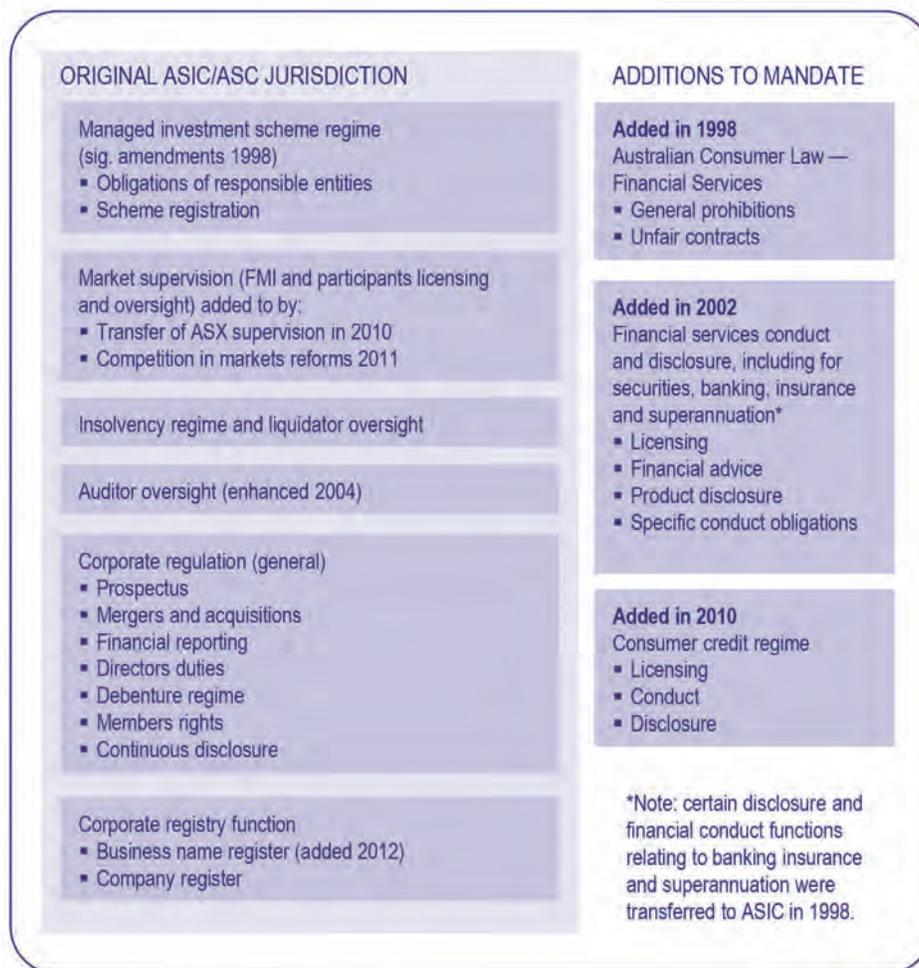
<sup>38</sup> Australian Prudential Regulatory Authority 2014, First round submission to the Financial System Inquiry, page 26.

and businesses; for example, the move of consumer credit from a fragmented, state-based regulatory system to a single national regulator.

The responsibilities in ASIC’s registry business have also expanded; for example, through the recent takeover of business name registration from the states and territories.

Thus, ASIC now manages a diverse range of tasks and therefore requires a cultural and skills mix that allows it to perform supervision, business guidance, consumer education, law enforcement and corporate registry. One issue is whether these increased responsibilities have been sufficiently matched by increased resources.

**Figure 7.3: Breadth of ASIC mandate**



The Inquiry notes the Senate inquiry into the performance of the ASIC which is currently underway. Relevant findings will be considered by the Inquiry in the lead-up to the Inquiry's final report.

Given the breadth of ASIC's mandate, it can be argued that ASIC has too many regulatory functions, with staff spread between too many responsibilities. It is possible that narrowing ASIC's mandate may allow it to become a more tightly focused regulator and target higher-risk entities, although there are also benefits and efficiencies from bringing together similar functions.

Some stakeholders have raised the option to split consumer protection functions from conduct and market integrity functions.

Some stakeholders suggest generic consumer regulation contained in the ASIC Act could be moved to the ACCC. The main challenge with this option would be drawing a clear line between generic consumer protection provisions and specific provisions tailored to financial products and services.

Other stakeholders have suggested moving industry-specific consumer regulation, which includes relevant licensing regimes, either to a new, specialised consumer and conduct regulator or to the ACCC. This would leave ASIC responsible for corporate regulation, and markets and wholesale activity.

Both these options could potentially lead to duplication and issues of boundary definition, and would mean that the agency acquiring the new responsibilities would need to develop (or acquire from ASIC) the relevant financial services expertise.

Other options include:

- Splitting market supervisory activities (i.e. FMI and participants licensing and oversight) into a specialised market supervisor
- Moving insolvency functions to the Australian Financial Security Authority (AFSA)
- Moving the registry function out of ASIC

Regarding this last option, the Government has already announced a scoping study into options for future ownership of this function. Arguably, the registry function aligns least well with other core ASIC functions.

It may also be possible to increase the emphasis on oversight of self-regulating bodies. This would allow ASIC to lift its focus to higher-level breaches and leave lower-level investigations to industry bodies. ASIC itself has raised this possibility, but has noted that this depends on the capacity of these bodies to police their own members.

As for any proposed changes, significant evidence or arguments for change would be needed. The Inquiry generally opposes creating new regulatory bodies.

### Enforcement powers: ASIC

Regulators require a sufficient set of powers to execute their mandate and foster credibility with the market. Given the size and diversity of the regulated population, ASIC cannot conduct the intensive supervision typically performed by a prudential regulator.

Enforcement sends a deterrent message to industry and is an important aspect of the consumer regulatory framework. Effective supervision and enforcement builds trust and confidence in the financial system. However, ASIC cannot pursue all complaints received. Its enforcement activity targets areas of strategic priority and incidents with evidence or likelihood of consumer detriment.

When applying the market conduct and disclosure framework, ASIC’s submission demonstrates that criminal penalties in Australia appear to be broadly consistent with overseas regimes, but civil and administrative penalties are comparatively low, as shown in Table 7.2 below.

ASIC’s mandate also has important gaps when compared to major domestic and international jurisdictions. For non-criminal proceedings, ASIC does not have the power of disgorgement available in Canada, Hong Kong, the United Kingdom and the United States. ASIC cannot impose fines on AFSL holders, although it can suspend or revoke their licence. Penalties available to the ACCC are higher than those available to ASIC.

**Table 7.2: Comparison of Australian and overseas jurisdictions’ civil and administrative penalties for individuals (AUD)**

	<b>Insider trading</b>	<b>Market manipulation</b>	<b>Disclosure</b>	<b>False statements</b>	<b>Unlicensed conduct</b>	<b>Inappropriate advice</b>
Australia	Civil: \$200,000	Civil: \$200,000	Civil: \$200,000	-	-	Civil: \$200,000
Canada	Admin: \$1.05 million	Admin: \$1.05 million	Admin: \$1.05 million	Admin: \$1.05 million	Admin: \$1.05 million	Admin: \$1.05 million
Hong Kong	Admin: unlimited	-	Admin: \$1.12 million	-	-	Admin: \$1.4 million, or 3 times the benefit gained
United Kingdom	Civil and admin: unlimited	Civil and admin: unlimited	Civil and admin: unlimited	Civil and admin: unlimited	-	Admin: unlimited
United States	Civil: three times the benefit gained	Civil: greater of \$111,000 or the benefit gained	Civil: greater of \$111,000 or the benefit gained	Civil: greater of \$111,000 or the benefit gained	Civil: greater of \$111,000 or the benefit gained	Admin: \$83,850

Source: ASIC.<sup>39</sup>

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<sup>39</sup> Australian Securities and Investments Commission (ASIC) 2014, First round submission to the Financial System Inquiry, page 48.

## Talent management

### *Observation*

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

Regulators face challenges in recruiting and retaining staff, given regulatory staff remuneration falls short of salaries in the industry they regulate, and against whom they compete for personnel. Another hurdle is the perception that APRA and ASIC's operational independence and effectiveness is unduly hampered by public sector operating constraints. For example:

- The public service enterprise bargaining process, and the constraints it imposes on APRA and ASIC's abilities to negotiate an appropriate enterprise agreement with their staff, have created uncertainty for APRA and ASIC staff with respect to future remuneration and advancement opportunities. The constraints on APRA and ASIC's abilities to set terms and conditions for staff may detract from the regulators' ability to attract and retain qualified staff.
- ASIC has advised that the inflexibilities involved in Australian public service employment under the *Public Service Act 1999* can make it difficult for ASIC to shape the workforce and culture that it requires to meet the organisation's priorities. Examples of inflexibilities relate to:
  - Classification and remuneration of staff
  - Length of employment of temporary staff
  - Management decisions affecting staff
  - The terms and conditions of any enterprise agreement

Unlike ASIC, neither APRA nor the RBA are subject to the *Public Service Act 1999*.

## Policy options for consultation

### Strengthening of competition considerations through mechanisms other than amending the regulators' mandates

The Inquiry seeks views on the following options to emphasise competition matters beyond amending mandates:

- Requiring the RBA to report every three years on the efficiency and competitiveness of the Australian financial system.
- Appointing an additional APRA member or establishing another mechanism for considering the impacts of regulatory intervention on competition. APRA's view is that appointing an additional member would be counter to best-practice governance principles, under which all members are responsible for decisions.
- Requiring APRA's annual report to include a section on competition.

Introducing stronger accountability mechanisms for the regulators could assist in ensuring all existing objectives are given due consideration.

### Refine the scope and breadth of ASIC's mandate

Options for narrowing ASIC's mandate could include moving consumer protection functions to the ACCC or a new financial consumer protection agency, creating a new financial services and conduct regulator, creating a new specialised market supervisor, moving insolvency functions to AFSA and removing the registry function.

### Review the penalty regime in the Corporations Act

A stronger penalty regime could strengthen the impact of ASIC's enforcement action and provide a more effective deterrent message against misconduct. A review of penalties under ASIC-administered legislation could explore:

- The adequacy of maximum criminal penalties
- The availability and level of civil penalties, including the potential of using multiples of benefit obtained and converting the current maximums into penalty units
- The availability of administrative penalties
- Introducing disgorgement in non-criminal proceedings to remove any financial benefit, including profits or avoided losses, obtained illegally

- Whether the infringement notice regime should be expanded to cover more contraventions

### Review mechanisms to attract and retain staff, including terms and conditions

The incentives and remuneration necessary to attract the highest quality pool from which to select and retain regulator staff could be broadened. A range of policy options follow to achieve this outcome.

APRA and ASIC should have flexibility regarding the terms and conditions under which they employ staff and determine remuneration. One option for providing this flexibility would be to exempt APRA and ASIC from the public sector bargaining framework and, to the extent it applies, the Public Service Act.<sup>40</sup> APRA and ASIC could strengthen transparency and accountability in this area by providing appropriate additional information on remuneration levels and other staffing metrics (such as projected staff levels) in annual reports.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

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<sup>40</sup> Note the starting positions of the two regulators are different: APRA is subject to the public sector bargaining framework, but is exempt from the Public Service Act employment conditions.

*The Inquiry seeks further information on the following areas:*

- Are changes needed to strengthen and/or refocus ASIC?
- Is the current enforcement regime adequate? Does ASIC have adequate powers?
- Are there alternative mechanisms for promoting better consideration of competition within financial sector regulation?



## Emerging Trends

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Over the coming decades, Australia will confront a number of continuing trends as well as new drivers of change for the financial system, creating both opportunities and risks. These changes include our ageing population, technological change and Australia's international integration. To varying degrees, these trends are already manifesting themselves.

<b>8: Retirement income</b>	<b>4-3</b>
<b>9: Technology</b>	<b>4-35</b>
<b>10: International integration</b>	<b>4-73</b>



## 8: Retirement income

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Australians save for retirement during their working years. When they retire, they use their accumulated wealth to generate income and help manage risks over the remainder of their lives. They require appropriate financial products and services to help them achieve their retirement goals.

There is an opportunity for financial and policy innovation to deliver better outcomes for retirees and assist Australia to meet the challenge of an ageing population. This chapter explores some of the weaknesses of the retirement income system and impediments to the development of new products. In particular, longevity risk is not currently managed efficiently.

The Inquiry has made the following observations about Australia's retirement income system:

- The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.
- There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.

### Context

#### Approach to retirement income

Australia has an inconsistent approach to its retirement income system. Policy related to the accumulation phase is based on the premise that many people underprovision for their retirement and are prone to behavioural biases, which motivates the use of default and compulsion arrangements. The policy settings for the decumulation (or drawdown) phase generally take a more laissez-faire approach. There is an implicit assumption that individuals have the capacity and options available to them to manage their income and risks in retirement.

A large body of evidence in behavioural economics – much of which has emerged since the Wallis Inquiry – demonstrates that poor outcomes can emerge from complex decision making at critical junctures, such as for retirement. Making decisions to manage income and risks in retirement is complex, even for people with specialised financial training. As stated in the *Consumer outcomes* chapter, affordable and high-quality financial advice can bring significant benefits for retirees, and the quality of financial advice could be improved.

If superannuation benefits are not transformed into retirement income streams effectively, taxpayers ultimately carry significant risk in the form of higher Age Pension costs.

### Demographic challenge

Australia faces a significant demographic challenge. The number of people aged 75 or older is expected to rise by 4 million between 2012 and 2060; this represents an increase from about 6½ to 14½ per cent of the population.<sup>1</sup> The ageing population and higher life expectancy is expected to result in lower workforce participation rates, which will tend to lower the trend rate of growth in the economy and raise costs for governments.

The life expectancy of Australians is among the longest in the world. For the first half of the 20<sup>th</sup> century, life expectancy for 65-year-olds was broadly constant, but it has increased by one to two years each decade since the 1970s. Life expectancy at age 65 is forecast to increase further (Chart 8.1). In 2014, the most commonly used life expectancy measure for a 65-year-old male is about 20 years.<sup>2</sup> However, because of likely future improvements in longevity, 22 years is a more realistic estimate.<sup>3</sup>

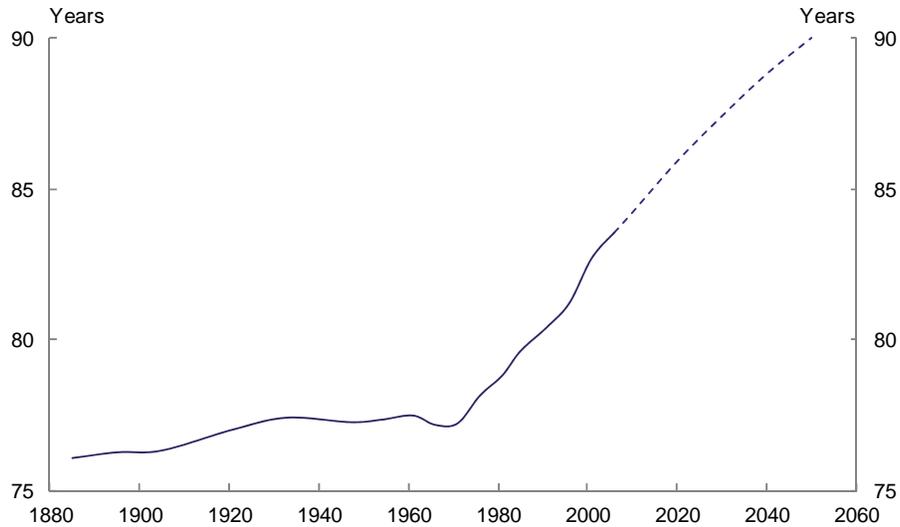
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1 Productivity Commission 2013, *An Ageing Australia: Preparing for the Future*, Productivity Commission, Canberra.

2 Life expectancies are usually reported as ‘period’ life expectancies. Period life expectancies take into account improvements in mortality that have been observed to date but not projected future changes to mortality. They may therefore understate life expectancies.

3 Australian Government Actuary 2014, data provided to Financial System Inquiry, 21 May 2014.

**Chart 8.1: Life expectancy of a 65-year-old Australian male**



Source: Australian Government Actuary.<sup>4</sup>

The ageing population presents a major challenge for the financial system. Australia needs a suitable range of financial products and services to enable a greater number of individuals to manage income and risks in retirement and to help manage the transition from work to retirement.

The ageing population also has implications for government finances. This will contribute to higher government costs from the Age Pension, health and aged care.

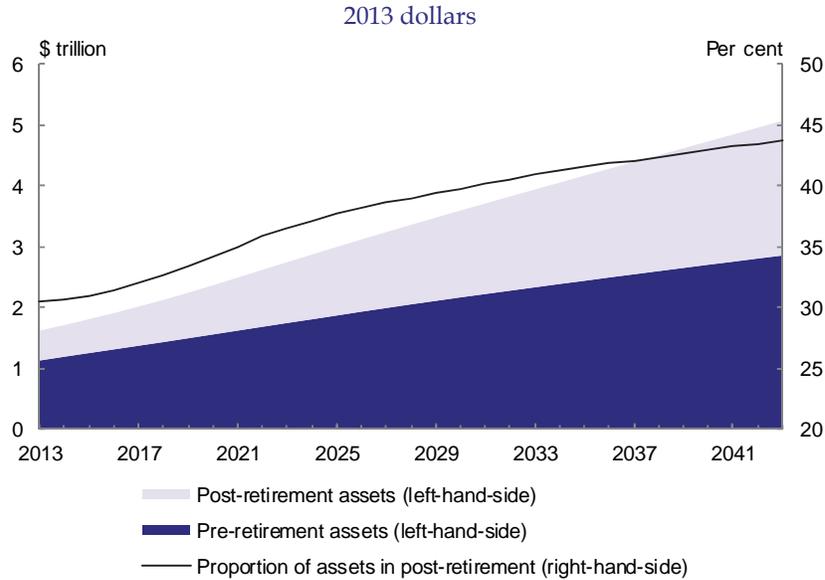
### The growing size of retirement assets

The volume and proportion of superannuation assets held by retirees is forecast to increase substantially (Chart 8.2). This growth is due to the maturing superannuation system and population ageing.<sup>5</sup>

4 Commonwealth of Australia 2009, *Australian Life Tables 2005–07*, Canberra. ‘Period’ life expectancies using 25-year mortality improvement factors.

5 The superannuation system could be considered mature when retirees have benefited from contributions at the maximum Superannuation Guarantee rate over their entire careers.

**Chart 8.2: Superannuation assets in the retirement phase**



Source: Rice Warner.<sup>6</sup>

### Available products

Currently, Australians who wish to convert their superannuation assets into an income stream within the tax-advantaged superannuation environment largely have the choice of two products:

- **Account-based pensions** account for at least 94 per cent of current pension assets.<sup>7</sup> They allow retirees to choose their investment strategy. People can decide how much to draw down (subject to prescribed minimums), and they can make a lump sum withdrawal at any time. Most people draw down the minimum amount.<sup>8,9</sup> Account-based pensions are offered by superannuation funds.
- **Annuities** provide a guaranteed regular income stream for an upfront lump sum payment or a series of smaller payments. Retirees receive income over a specified time horizon (fixed-term annuities) or for the remainder of their life (lifetime

6 Rice Warner 2014, *Ageing and capital flows*, commissioned by the Actuaries Institute for the Financial System Inquiry.

7 Plan for Life 2014, data provided to Financial System Inquiry, 23 June 2014.

8 Rothman, G and Wang, H 2013, 'Retirement income decisions: Take up and use of Australian lump sums and income streams', paper presented at the *21st Colloquium of Superannuation Researchers*, Sydney, 9–10 July.

9 The minimum drawdown rate to qualify for the tax exemption on earnings currently ranges from 4 per cent for those aged under 65 to 14 per cent for those aged over 95.

annuities). ‘Indexed annuities’ protect this income from the effects of inflation. Annuities are sold by life insurance companies.

The current dominance of account-based pensions over annuities is due to a range of factors, including the flexibility of account-based pensions, which allow both lump sum withdrawals and residual assets for bequests, the perceived lack of value provided by annuities, and the fact that individuals can rely on the Age Pension to help manage longevity risk.

### International comparison

A striking difference between Australia’s retirement income market and those of other developed countries is the size of its annuity market. According to the OECD, the size of Australia’s annuity market is only around 0.3 per cent of GDP, compared with 28.8 per cent in Japan, 15.4 per cent in the United States, and more than 40 per cent of GDP in some European countries.<sup>10, 11</sup> The Government bears much of Australia’s longevity risk by providing the Age Pension, which contributes to the low demand for longevity-protected income products.

### Implications for funding the economy

The investment allocations underlying income stream products can affect aggregate demand for different assets and the depth of certain markets. This will become increasingly important as retirement assets increase. Current retirement income products invest in different ways:

- Individuals with account-based pensions typically invest in portfolios that are evenly split between growth and defensive assets.<sup>12</sup>
- Annuity liabilities are used to fund assets that are predominantly invested in fixed income investments, although a portion of these assets are infrastructure and property investments with appropriate characteristics, such as providing regular cash flows.<sup>13</sup>

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10 OECD 2013, ‘Survey of Annuity Products and their Guarantees’, paper presented at the *Insurance and Private Pensions Committee meeting*, Paris, 5–6 December.

11 The OECD defines size as the amount of assets backing products (where dedicated or separated accounts back the products) or technical provisions or reserves.

12 Rice Warner 2014, *Ageing and capital flows*, commissioned by the Actuaries Institute for the Financial System Inquiry.

13 Plan for Life 2014, data provided to Financial System Inquiry, 18 March 2014.

## Framework

At retirement, individuals face complex decisions about whether and how to convert an accumulated superannuation balance to an income stream to fund their retirement. In this chapter, the retirement income system and products are assessed against how well they provide the three main attributes of income streams desired by retirees:<sup>14</sup>

- **Income** — the expected income during retirement from a given accumulated balance.<sup>15</sup>
- **Risk management** — including protection from longevity, investment and inflation risks.
- **Flexibility** — a range of characteristics, including access to one-off withdrawals during retirement, the ability to bequeath assets and control over investments.

The Inquiry is also considering the effects of retirement income system settings on the distribution of risk between the government and the private sector and, to some extent, the implications for future growth in fiscal costs. Fiscal sustainability is an important feature of any retirement income system, although it is not something that can be comprehensively examined in isolation from the rest of the government's budget.

The Inquiry is not considering a range of policy settings outside of, or peripheral to, the financial system, including the ages at which individuals can access their benefits and receive these benefits tax-free.

## The retirement income system

### Preliminary assessment

#### *Observation*

The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.

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<sup>14</sup> Similar features of income products, which create a 'trilemma' for retirees, are described in Mercer 2014, First round submission to the Financial System Inquiry, page 23.

<sup>15</sup> The measure of 'income efficiency' used is based on a 'value for money' concept. It is the expected present value of income in retirement, as a percentage of a product's purchase price.

Individuals are justifiably concerned about outliving their savings. As it is currently designed, the retirement income system does not adequately enable many individuals to manage their income and risks in retirement effectively.

During the accumulation phase, employers make Superannuation Guarantee contributions automatically on behalf of employees, with defaults applying to those who are less engaged with the system. This framework effectively guides individuals through the accumulation phase. However, such a framework does not exist for the retirement phase. Instead, retirees make critical once-in-a-lifetime decisions regarding when and how to draw down their savings over the remainder of their lives. Individuals also have to manage the investment, inflation and longevity risks associated with these decisions. Many, but not all, individuals are unprepared for these important decisions.

The lack of effective risk management, particularly longevity risk management, is a major weakness of Australia’s retirement income system.

### Assessment of current products

As discussed in the *Framework* section of this chapter, retirees require income products that deliver three main features: income, risk management and flexibility. No product provides all of these features (Table 8.1). Account-based pensions are more flexible than annuities but provide much less risk management. Thus, current retirees benefit from two of the three features they need, but the majority do not effectively manage risk.

**Table 8.1: Features of retirement income products**

	Account-based pension	Lifetime annuity
<b>Income</b>	<ul style="list-style-type: none"> <li>✓ Difficult for retirees to decide how much to withdraw</li> <li>Payments cease when balance is exhausted</li> </ul>	<ul style="list-style-type: none"> <li>✓ Payments continue for life</li> <li>Purchase price includes margins, some of which are for servicing capital</li> </ul>
<b>Flexibility</b>	<ul style="list-style-type: none"> <li>✓✓ Complete flexibility of withdrawals (subject to statutory minimum)</li> <li>Residual balance at death available for bequests</li> </ul>	<ul style="list-style-type: none"> <li>✗ Non-commutable</li> <li>Generally no residual balance at death</li> </ul>
<b>Risk management</b>	<ul style="list-style-type: none"> <li>✗ Individual exposed to longevity, inflation and investment risks</li> </ul>	<ul style="list-style-type: none"> <li>✓✓ Provides complete longevity risk protection</li> <li>Indexed annuities also provide inflation risk protection</li> </ul>

One important feature of a retirement income product is the expected income it delivers during retirement from a given accumulated balance. In this report, 'income efficiency' is defined as the expected present value of this income as a percentage of the purchase price of the product.

A lifetime annuity has an estimated income efficiency of 76 per cent for an average 65-year-old male (for reasons discussed later in this chapter).<sup>16</sup> The income efficiency of an account-based pension that is drawn down at the minimum rate for a 65-year-old male is around 70 per cent.<sup>17</sup> The remaining funds in an account-based pension will typically be left to beneficiaries.

There are trade-offs between income efficiency, flexibility and risk management. For example, a higher drawdown rate will increase the income efficiency of an account-based pension, as a larger portion of the pension is expected to be paid as income during the life of the retiree, but will increase the risk of outliving savings.

### Longevity risk

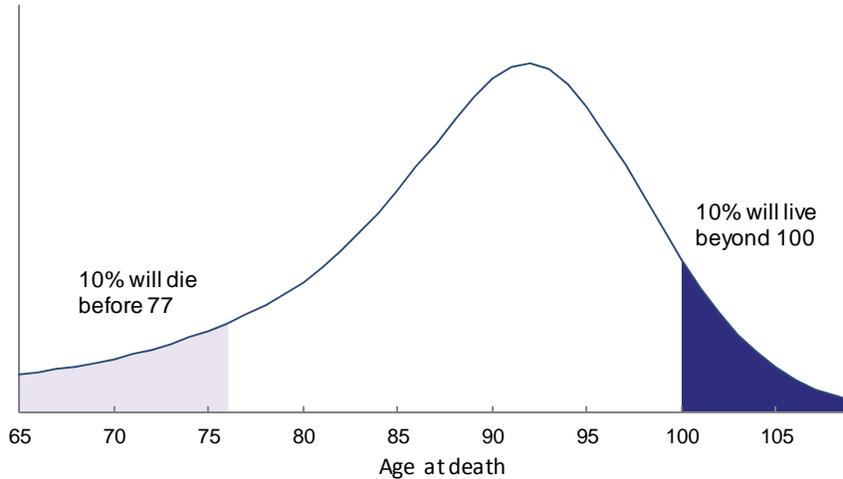
Most individuals risk outliving their savings. Uncertainty around the length of time in retirement makes it difficult for people to manage their wealth efficiently. For example, although the life expectancy of a 65-year-old female today is about 89 years, 10 per cent of 65-year-old females will die before they reach 77 years and 10 per cent will live past 100 years (Chart 8.3).

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<sup>16</sup> Ganegoda, A 2007, 'Explaining the Demand for Life Annuities in the Australian Market', *Centre for pensions and superannuation*, discussion paper, May 2007.

<sup>17</sup> Estimate provided to the Financial System Inquiry by the Australian Government Actuary, 11 June 2014.

**Chart 8.3: Distribution of cohort life expectancy for a 65-year-old female**



Source: Australian Government Actuary.<sup>18</sup>

This uncertainty makes it difficult for people to choose the ‘right’ rate at which to draw down their wealth from an account-based pension. Retirees risk either exhausting their retirement savings prematurely (and falling back on the Age Pension), or drawing down their benefits too conservatively and having a lower standard of living in retirement.

Managing longevity risk on an individual basis can lead to a dynamically inefficient allocation of resources. To reduce the risk of outliving their assets, individuals need a higher savings rate during their working life to target a given level of consumption in retirement. This can lead to inefficiently low consumption during an individual’s working life. Alternatively, insufficient provisioning for retirement leads to inefficiently low levels of consumption in retirement.

In Australia, the total cost of this inefficiency is likely to be substantial, given both the large number of people with account-based pensions who draw down their funds at the minimum rate, and the large proportion of older Australians receiving the Age Pension.<sup>19</sup> The cost is largely borne by retirees and, to a lesser extent, the Government through the total cost of tax concessions and Age Pension payments.

18 Commonwealth of Australia 2009, *Australian Life Tables 2005–07*, Canberra. Using 25-year mortality improvement factors.

19 As discussed earlier, at least 94 per cent of pension assets are in account-based pensions and most drawdowns are at minimum rates.

A large body of evidence, including from surveys, supports the assertion that people value longevity risk protection. Results from one survey suggest that more than 90 per cent of Australians over the age of 50 believe that 'money that lasts my lifetime' is somewhat important or very important.<sup>20</sup> Over half of respondents to another survey were either worried or extremely worried about outliving their savings.<sup>21</sup> When asked to identify the single most important feature in a retirement income product, twice as many members in the accumulation phase identified 'income that lasts a lifetime' as identified the second most popular response.

### Lump sums

Several submissions refer to Australia's (real or perceived) 'lump sum culture' and call for a shift towards income streams and longevity risk management in retirement.

In general, superannuation funds seek to maximise a member's lump sum balance at retirement, rather than target a level of income in retirement. This is a common feature of defined contribution schemes globally.

Around half of superannuation benefits in retirement are currently paid as lump sums.<sup>22</sup> Close to half of retirees take a lump sum only – having never received an income stream payment.<sup>23</sup> For people with small superannuation balances, taking the entirety of their benefits as a lump sum may be an optimal strategy because the income stream generated from a small balance is negligible and has relatively high costs and no tax advantages. However, as more people retire with higher account balances, there has been a gradual trend towards purchasing income stream products (Chart 8.4).

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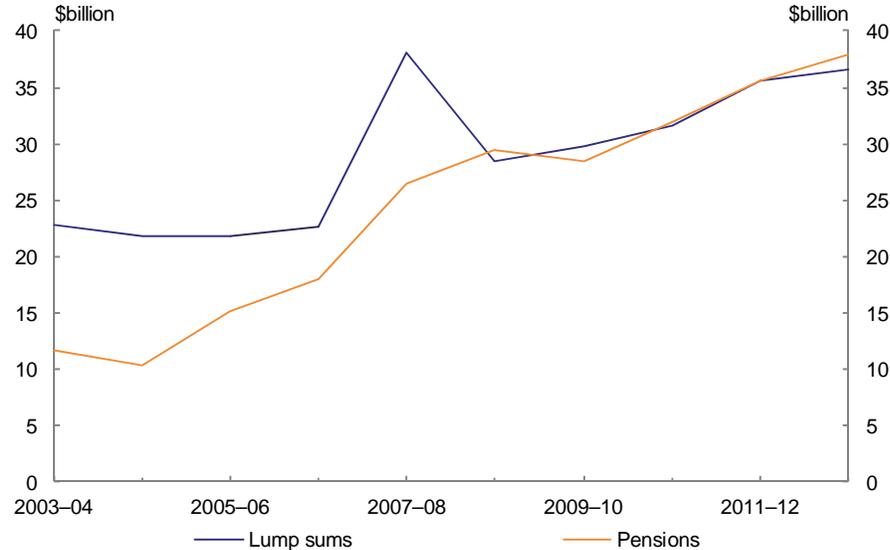
20 National Seniors Australia and Challenger 2013, *Retirees' needs and their (in)tolerance for risk*, National Seniors Australia, Brisbane.

21 Investment Trends 2013, *December 2013 Retirement Income Report*. Note: Based on a survey of 5,730 Australians aged 40+.

22 APRA 2013, *Annual Superannuation Bulletin*, June 2013 (revised 5 February 2014).

23 Rothman, G and Wang, H 2013, 'Retirement income decisions: Take up and use of Australian lump sums and income streams', paper presented at the *21st Colloquium of Superannuation Researchers*, Sydney, 9–10 July.

**Chart 8.4: Superannuation benefit payments – lump sums and pensions**



Source: APRA.<sup>24</sup>

The ability to use superannuation lump sums to extinguish debt can encourage higher pre-retirement consumption and borrowing:<sup>25</sup>

- Approximately 44 per cent of retirees who take a lump sum use it to pay off housing and other debts, to purchase a home, or make home improvements.
- A further 28 per cent use their lump sum to repay a vehicle or holiday loan or to purchase a holiday or new vehicle.

The number of households entering retirement with debt, particularly a mortgage, is increasing.

24 APRA 2013, *Annual Superannuation Bulletin*, June (revised 5 February 2014), APRA, Sydney. *Lump sum benefit payments* are benefit payments paid as a lump sum and includes (but is not limited to) retrenchment, redundancies, resignation and disability benefit payments. This item does not include lump sum rollovers or pension benefit payments. *Pension benefit payments* refer to benefits paid to members in the form of a pension and include complying pensions, allocated pensions and annuity payments.

25 Rothman, G and Wang, H 2013, 'Retirement income decisions: Take up and use of Australian lump sums and income streams', paper presented at the *21st Colloquium of Superannuation Researchers*, Sydney, 9-10 July.

## Age Pension means-test

The Age Pension means-test can distort financial decisions made before and during retirement.

Butler, Peijnenburg and Staubli concluded that a pension means-test can substantially reduce demand for longevity insurance products.<sup>26</sup> The Age Pension in Australia is the primary source of longevity insurance and is contributing to the low demand for market-based products that provide such insurance.

Similarly, Hulley, McKibbin, Pedersen and Thorp found that means-tests for the public pension encourage eligible and near-eligible retirees to decumulate assets faster and choose riskier portfolios, especially early in retirement.<sup>27, 28</sup> This distorts the amount of risk eligible and near-eligible retirees expose themselves to and shifts longevity risk to the Government.

Stakeholders have suggested that some individuals with small- and medium-sized asset balances tend to structure their affairs around the Age Pension means-test. Indeed, maximising access to the Age Pension is (understandably) a central feature of financial advice for retirees. Mercer's submission illustrates the reasons for this by looking at the case of 'Fred'<sup>29</sup>:

*Fred is a single (home-owner) retiree with a \$500,000 account based pension. He is drawing down the minimum 5 per cent of the account each year. By spending \$100,000 of his superannuation account on an overseas trip, Fred increases his age pension by \$150 a fortnight (\$3,900 a year).*

*If he continues to draw down the minimum allowed from his account based pension, his withdrawals reduce by \$5,000 a year meaning he is only \$1,100 a year (or \$21 per week) worse off after his \$100,000 overseas trip.*

There is no empirical evidence of this behaviour on a large scale. However, a significant portion of superannuation savings are being depleted before reaching Age Pension age. On average, around one-third of superannuation assets are withdrawn by

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26 Butler, M, Peijnenburg, K and Staubli, S 2011 'How Much Do Means-Tested Benefits Reduce the Demand for Annuities?' *CESifo Working Paper Series No. 3493*, Munich.

27 Hulley, H, McKibbin, R, Pedersen, A, and Thorp, S 2013, 'Means-Tested Public Pensions, Portfolio Choice and Decumulation in Retirement', *Economic Record*, Volume 89, Issue 284, pages 31-51.

28 For people with large balances, there are tax incentives to decumulate assets more slowly. Slower drawdown also reduces the risk of outliving assets. The interaction of these effects differs depending on individual circumstances.

29 Mercer 2014, First round submission to the Financial System Inquiry, page 11.

the time an individual reaches the Age Pension eligibility age.<sup>30</sup> Around one-quarter of people with a superannuation balance at age 55 have depleted their balance by age 70.<sup>31</sup> Aligning incentives with desired outcomes would tend to reduce the longevity risk borne by the Government. It would also improve the capacity of future Governments to provide the Age Pension to the many Australians who will need it in retirement.

### Defaults cease at retirement

Many individuals are not required to interact with their superannuation fund during their working lives. Employers make Superannuation Guarantee contributions automatically on behalf of employees. If employees do not nominate a fund or investment option, contributions are made to a default fund chosen by the employer, and investment decisions are made by professionals.

These superannuation defaults cease at retirement. Retirees make once-in-a-lifetime critical decisions about how to manage their assets, ideally to deliver an income stream and to manage effectively the associated investment, inflation and longevity risks. The consequences of a poor decision can be severe and costly to rectify; individuals typically have limited or no capacity to top up their funds after they retire. Benefits remain in a superannuation fund until an active decision is made. Assets held in a superannuation account are not used to provide income, and the returns on these assets are not exempt from tax.

A number of studies have reported that Australians are unprepared for the financial decisions they need to make as they approach retirement. They know neither how much to save for retirement nor how to create income from their accumulated balance: most people in their 50s and 60s have not planned the main aspects of their retirement,<sup>32</sup> and only one-third of accumulating superannuation members have heard of lifetime annuities.<sup>33</sup> As discussed in the *Consumer outcomes* chapter, this highlights the importance of high-quality financial advice for retirees and those near retirement.

Other countries with defined contribution schemes face similar challenges to those in Australia. The prestigious Squam Lake Working Group found that defined contribution schemes “place much greater burdens on consumers to make good

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30 Commonwealth of Australia 2009, *Australia's future tax system – The retirement income system: Report on strategic issues*, Canberra.

31 Bray, J 2013, 'In the red and going grey? Wealth and debt as Australians approach Age Pension eligibility age and retirement', *Crawford School Research Paper No. 04/2013*, Canberra.

32 Agnew, J, Bateman, H and Thorp, S 2012, 'Work, money, lifestyle: Plans of Australian retirees', *ARC Centre of Excellence in Population Ageing Research Working Paper 2012/22*.

33 Bateman, H, Eckert, C, Geweke, J, Iskhakov, F, Louviere, J, Satchell, S and Thorp, S 2013, 'Disengagement: A Partial Solution to the Annuity Puzzle', *UNSW Australian School of Business Research Paper No. 2013ACTL10*.

financial decisions. There is widespread concern that many households are not up to the task".<sup>34</sup>

### Low demand for longevity-protected products

There is low demand in Australia for products that provide protection against longevity risk. Annuities are currently the only market-based products that provide longevity insurance.

Academics have struggled to solve the 'annuity puzzle' — the fact that while annuities deliver desirable characteristics, demand for annuities is very low.<sup>35, 36, 37</sup> A range of behavioural biases have been found to discourage people from purchasing products with longevity protection:

- Annuities are perceived to be risky gambles rather than insurance.
- Individuals underestimate their life expectancy.
- Retirees want the flexibility to meet unforeseen cash requirements and leave their residual assets as a bequest.
- Individuals undervalue future consumption relative to current consumption.
- Annuities are not perceived to deliver value for money.

A range of factors reduce the attractiveness of annuity pricing and increase the attractiveness of account-based pensions.

Life insurance companies impose various margins on annuities that increase their price for a given income stream. These companies must use significant capital to fund their assets and minimise the risk of failure. They must cover administrative costs and provide profits to shareholders.

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34 Squam Lake Working Group on Financial Regulation 2009, 'Working paper on the regulation of retirement saving', Council on Foreign Relations Press, New York.

35 When asked about their worries in retirement, two of the three most common responses of retirees were "outliving retirement savings" and "falls in financial markets". Source: Investment Trends 2013, *December 2013 Retirement Income Report*. Note: Based on a survey of 5,730 Australians aged 40+.

36 The seminal paper showing that rational retirees should annuitise their benefits was Yaari, M 1965, 'Uncertain Lifetime, Life Insurance, and the Theory of the Consumer', *The Review of Economic Studies*, Vol. 32, No. 2, April 1965, pages 137-150.

37 Recently, Australian research found that longevity-protected products form part of the optimal portfolios for retirees. Hanewald, K, Piggott, J and Sherris, M 2013, 'Individual post-retirement longevity risk management under systematic mortality risk', *Insurance: Mathematics and Economics*, vol 2013, Elsevier, London, pages 87-97.

Annuities are also made more costly by adverse selection. Individuals usually have more information about the factors affecting their own life expectancy than retirement product providers. Those expecting to live longer are more likely to buy longevity-protected products. Providers will respond by setting prices appropriate for those likely to live longer lives, which makes the pricing unattractive for others. Challenger estimates that for a 65-year-old male buying an annuity in the current environment, adverse selection lowers indexed annuity payments by around 7 per cent (from around \$6,000 annually per \$100,000 premium to \$5,600).<sup>38</sup>

Annuity prices are also affected by the level of interest rates when they are purchased. The lower level of interest rates over the past 20 years has reduced the income generated from annuities (and some other investments), although this has also been associated with a reduction in inflation.

Finally, retirees have what they perceive to be attractive alternatives to annuities:

- Account-based pensions invested in high-yielding equities may offer attractive returns compared to annuities, in part due to the benefits of dividend imputation.
- The Financial Claims Scheme removes counterparty risk for retirees who save through bank deposit products and term deposits, but not annuities.
- The Age Pension provides government-backed longevity protection.

## Policy options for consultation

### Perspectives on retirement income policy options

A number of reviews, and other countries, have found that a retirement income system should provide a guide to retirees for managing longevity risk and achieving outcomes that suit their individual circumstances, regardless of their level of financial literacy, engagement or superannuation balance.

As a general principle, major changes to the retirement income system need to consider the policy settings in the tax and transfer system. These settings are outside the scope of the Inquiry's Terms of Reference.

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<sup>38</sup> Challenger 2014, data provided to Financial System Inquiry, 4 June 2014.

## The Super System Review

The Super System Review Panel's ten 'Super policy principles' included the following:

*Financial literacy is an important long term goal, but a compulsory superannuation system cannot depend on all its participants having the skills necessary to comprehend complex financial information or being investment experts.*<sup>39</sup>

## The OECD roadmap

The OECD has developed a roadmap for improving defined contribution pension plans to produce better outcomes in retirement.<sup>40</sup> Four of the recommendations are relevant to the retirement phase:<sup>41</sup>

1. Encourage annuitisation as a protection against longevity risk
2. Promote the supply of annuities and cost-efficient competition in that market
3. Develop appropriate information and risk-hedging instruments to facilitate dealing with longevity risk
4. Ensure effective communication and address financial illiteracy and lack of awareness

These recommendations provide a guide only. For example, as discussed later in this chapter, there are products other than annuities that provide longevity protection. The elements of the roadmap mentioned above have not been implemented in Australia.

## International comparisons

Australia is unusual in neither mandating nor encouraging the use of income streams with longevity protection in retirement (Table 8.2). Information provided to the Inquiry by Centre of Excellence in Population Ageing Research (CEPAR) notes that Australia "is the only developed economy with mandatory retirement saving to have no decumulation structure".<sup>42</sup>

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39 Commonwealth of Australia 2010, *Super System Review Final Report, Part One, Overview and Recommendations*, Canberra.

40 OECD 2012, *The OECD roadmap for the good design of defined contribution pension plans*, OECD, viewed 12 June 2014, <<http://www.oecd.org/finance/private-pensions/50582753.pdf>>.

41 Financial literacy and disclosure are discussed in the *Consumer outcomes* chapter.

42 Centre of Excellence in Population Ageing Research 2014, data provided to Financial System Inquiry, 10 June 2014.

**Table 8.2: Requirements for benefits to be taken as an income stream for countries with defined contribution systems**

Country	What are the requirements, if any, where a retirement benefit from a defined contribution (DC) plan is to be taken as an income stream?
Australia	There is no requirement to take an annuity but for those who convert their benefit into a tax-advantaged drawdown product, there is a minimum drawdown each year based on the member's age.
Canada	In most circumstances, the benefit from a registered DC plan must be transferred to a locked-in retirement account, a Life Income Fund (LIF) or an annuity. There are minimum and maximum withdrawal amounts from the LIF, which take into consideration the member's balance and age. There is no requirement for Registered Retirement Savings Plans but for those who convert their benefit into a tax-advantaged Registered Retirement Income Fund, there is a minimum withdrawal percentage based on age.
Chile	All benefits must be converted into a life annuity or a programmed withdrawal product, except for any portion of the benefit that is above the specified maximum.
Denmark	The tax rules provide no limit on the contributions paid into a DC plan if the benefit is taken as an annuity. However, there is a limit on the contributions if the benefit is paid out as instalments for a period of between 10 and 25 years. Contributions for other forms of benefits cannot be claimed as a tax deduction.
Netherlands	All retirement benefits must be converted into an annuity. Annuity payments are fixed but may be increased if profit sharing results allow for it. Several annuity options are available at retirement.
Singapore	The retirement benefit is converted into a life annuity if it is above a prescribed minimum. Amounts above the prescribed maximum do not need to be converted.
Sweden	All retirement benefits from a DC plan must be converted into an annuity, which could be a life annuity or a fixed term annuity, depending on the options available from the insurance company. However, the individual bears some risks as the insurance company can vary its assumptions and payments, even after the payments have commenced. Some policies guarantee a return of premiums.
United Kingdom	Following recently announced changes, from April 2015 up to 25 per cent of the accumulated retirement benefit may be taken as a tax-free lump sum. The remainder can be withdrawn as a lump sum (taxed at the individual's marginal tax rate), or taken as an annuity or other drawdown product.
United States	There are no requirements for DC plans (such as 401(k) plans) to provide annuities or income stream products.

Source: Mercer.<sup>43</sup>

## A spectrum of policy options

Policy settings should ensure that retirees can manage their accumulated balances in a way that improves retirement income and risk management, without transferring an excessive amount of longevity risk to the Government.

A spectrum of policy options is available to achieve the objectives of the retirement income system and position Australia to manage its demographic challenges better

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<sup>43</sup> Mercer 2013, *Melbourne Mercer Global Pension Index*, Australian Centre for Financial Studies, Melbourne (with the information for the United Kingdom updated following a change to arrangements there).

(Table 8.3). There are policy trade-offs along the spectrum between the degree of individual flexibility and freedom, and the benefits of effective pooling of risks.

This spectrum does not consider alternative approaches that involve more fundamental changes to the retirement income system, such as to the Age Pension.

**Table 8.3: A spectrum of policy options for superannuation in retirement**



	STATUS QUO	POLICY INCENTIVES	DEFAULTS	COMPULSION
<b>Key features</b>	Significant freedom for individuals Tax incentives for income streams	Create incentives for retirees to take benefits as longevity-protected income streams	Part of retirees' benefits to be taken in a longevity-protected product by default	A portion of benefits must be used to purchase a longevity-protected product
<b>Pros</b>	Individuals free to use their assets to fund retirement as they see fit	Can be effective while still allowing members freedom	Guides decision making Defaults are powerful drivers of behaviour Members retain the right to opt out	Ensures superannuation is used to provide income in retirement Addresses adverse selection issues
<b>Cons</b>	Limited access to effective risk management in retirement Significant risk to the Government of people falling back on the Age Pension	May require significant tax and social security concessions/penalties to be effective Potential Government fiscal implications	Limited ability for the member to opt out after the member is in a product Members have ability to opt out, take lump sums and fall back on the Age Pension	Denies individuals the ability to use their assets as they see fit Sub-optimal outcomes for some individuals, given heterogeneous circumstances Could disadvantage groups with lower life expectancies

## Status quo

A major theme of this chapter is how the retirement income system does not meet the risk management needs of many retirees. Potential improvements to the status quo, which do not necessarily involve fundamental changes to the system, include:

- Improving financial advice provided to individuals prior to retirement – as discussed in the *Consumer outcomes* chapter, affordable and high-quality financial advice can bring significant benefits for retirees.
- Removing barriers to developing new income products – as discussed later in this chapter.

## Policy incentives

The taxation and social security systems could be used to create strong incentives for retirees to take superannuation benefits as income streams that help manage longevity risk. There are already tax settings in place to encourage superannuation benefits to be taken as income streams, but these streams are not necessarily longevity protected. The Actuaries Institute submission notes:

*Given that the taxpayer ultimately bears the risk related to how individuals access and invest their retirement savings, it is reasonable that the Government proposes various incentives and/or restrictions on how superannuation fund assets can be drawn down.*<sup>44</sup>

It may be appropriate to have policies that discourage lump sums. Several submissions recommend restricting or discouraging lump sum benefit payments. For people with very small superannuation balances, lump sums may be the most appropriate way to draw down their benefits.

To be effective, the tax and social security implications of decisions may need to be significant. The fiscal costs of additional incentives would need to be appropriately targeted and offset by savings elsewhere to avoid increasing the overall cost of the retirement income system to Government.

## Defaults

Defaults could be introduced to the retirement phase of the system, potentially in conjunction with policy incentives. The Government could require that part of an individual's accumulated superannuation benefits be directed into a non-commutable income stream that provides protection against inflation and longevity risk, unless the individual opts-out. Potential products that could be appropriate defaults are

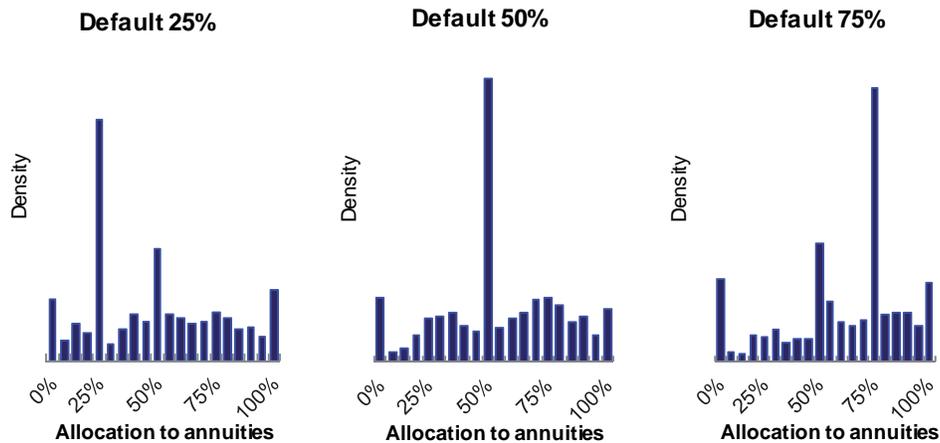
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<sup>44</sup> Actuaries Institute 2014, First round submission to the Financial System Inquiry, page 8.

discussed later in this chapter. Default arrangements could differ based on the size of the account balance, or other individual circumstances.

Defaults have powerful effects on decisions and can address the issue of low levels of financial literacy among retirees. One Australian experiment, which looked at the effect of default options on individuals allocating savings between account-based pensions and annuities, found that the distribution of allocations to annuities was strongly clustered around the default proportion (Chart 8.5).<sup>45</sup> Pension schemes with annuities as the default option tend to have high rates of annuitisation.<sup>46</sup> These findings are consistent with the high proportion of Australian employees who are members of their employers’ chosen default superannuation fund.

**Chart 8.5: Proportion of assets taken as an annuity with different default arrangements**



Source: Bateman et al.<sup>47</sup>

The World Bank recommends “countries that offer a constrained choice to retiring workers and do not mandate the use of a single retirement product for all should also specify the product that will be used as the default option. This will help workers who

45 Bateman, H, Eckert, C, Iskhakov, F, Louviere, J, Satchell, S and Thorp, S 2013, ‘Default and 1/N Heuristics in Annuity Choice’, *School of Risk and Actuarial Studies Working Paper 2014/1*.

46 Benartzi, S, Previtro, A and Thaler, R 2011, ‘Annuitization puzzles’, *The Journal of Economic Perspectives*, issue 25, vol 4, AEA Publications, Pittsburgh, pages 143–164.

47 Bateman, H, Eckert, C, Iskhakov, F, Louviere, J, Satchell, S and Thorp, S 2013, ‘Default and 1/N Heuristics in Annuity Choice’, *School of Risk and Actuarial Studies Working Paper 2014/1*.

are unable or unwilling to make a decision on their own and will protect them from abusive selling practices of brokers and selling agents of providers”.<sup>48</sup>

The Super System Review recommended that default MySuper products should be ‘whole of life’ by incorporating a retirement income stream product.<sup>49</sup> Under the recommended arrangement, trustees would consider longevity, inflation and investment risks in selecting a product. However, the previous Government decided that MySuper products would only cover the accumulation phase initially, so MySuper retirement benefits can only be paid as lump sums.

Default arrangements have other drawbacks. Since individuals can opt out, there remain incentives for retirees with small- and medium-sized balances to deplete assets early in their retirement and fall back on the Age Pension.

Then there is the difficulty of choosing default arrangements. No single product, or suite of products, meets all the needs of all retirees. ASFA’s submission notes the difficulty of setting up a system that suits all individuals due to the “complex maze of tax, social securities and savings interactions”, which differ depending on personal circumstances.<sup>50</sup>

## Compulsion

The Government currently mandates contributions into superannuation for a significant majority of Australian workers. At retirement, it could also require that all or part of superannuation benefits be moved into a non-commutable income stream that provides protection against inflation and longevity risk.

If annuities were selected for mandatory take-up, this would address adverse selection problems and should reduce their price. Research into annuity prices in the United Kingdom found that the effects of adverse selection in compulsory annuity markets are substantially lower than in voluntary annuity markets.<sup>51</sup>

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48 Rocha, R and Vittas, D 2010, ‘Designing The Payout Phase Of Pension Systems: Policy Issues, Constraints And Options’, *World Bank Policy Research Working Paper 5289*, The World Bank, Washington.

49 Commonwealth of Australia 2010, *Super System Review Final Report, Part One, Overview and Recommendations*, Canberra.

50 Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry, page 32.

51 Finkelstein, A and Poterba, J 2002, ‘Selection Effects in the United Kingdom Individual Annuities Market’, *The Economic Journal*, issue 112, Wiley, Oxford, pages 28-50.

If longevity protection were to be mandated, deferred products (discussed later in this chapter) may be appropriate. CEPAR notes some of the benefits of mandatory purchase of deferred lifetime annuities.<sup>52</sup> They include:

- Affordability
- The low amount of information asymmetry between retirees and providers regarding individual circumstances projected 20 or 25 years into the future
- A definite time horizon in which to use other assets to fund retirement
- Reduced problems associated with cognitive ability at older ages

A strong argument against compulsion is that it restricts the ability of individuals to tailor their retirement plan to suit their specific needs. This could result in worse outcomes for some retirees. Rocha and Vittas advise against mandating a high level of annuitisation, noting the benefits of a portfolio of retirement income products.<sup>53</sup> CEPAR notes that “[i]ndividual circumstances are far more heterogeneous in later life than they at earlier life stages, and mandate design can therefore be challenging”.<sup>54</sup> Indeed, the United Kingdom has announced reforms that, once implemented, will remove the effective compulsory annuitisation of privately accumulated retirement balances.

There are also concerns that a compulsory system would disadvantage groups in the community with lower-than-average life expectancies. However, this issue could be managed through product design. For example, in the United Kingdom, ‘enhanced’ or ‘impaired’ annuities, which pay higher incomes for the same purchase price, are available to people with certain medical conditions that lower their life expectancies.

### Trade-offs

There are trade-offs between individuals having more freedom and flexibility to decide how to draw down their benefits, and ensuring that the system facilitates effective risk management through pooling, which would more effectively deal with:

- Low levels of financial literacy and awareness

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52 Centre of Excellence in Population Ageing Research 2014, data provided to Financial System Inquiry, 10 June 2014.

53 Rocha, R and Vittas, D 2010, ‘Designing The Payout Phase Of Pension Systems: Policy Issues, Constraints And Options’, *World Bank Policy Research Working Paper 5289*, The World Bank, Washington.

54 Centre of Excellence in Population Ageing Research 2014, data provided to Financial System Inquiry, 10 June 2014.

- Behavioural biases preventing retirees from purchasing longevity protection
- The Government's exposure to longevity risk

Ideally, the retirement income system should facilitate individuals achieving the mix of income, risk management and flexibility appropriate to their circumstances, given their level of accumulated assets.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

A spectrum of options to achieve the objectives of the retirement income system and position Australia to manage the challenges of having an ageing population:

- Maintain the status quo with improved provision of financial advice and removal of impediments to product development.
- Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.
- Introduce a default option for how individuals take their retirement benefits.
- Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).

## Retirement income products

Regardless of the design of the retirement income system, it must include a suitable range of products.

*Observation*

There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.

## Preliminary Assessment

Choosing retirement income products necessarily involves trade-offs between income, flexibility and risk management. Australia has an opportunity to introduce new products that could help retirees achieve their desired levels of income, provide them

with flexibility and help them better manage risks. Currently, barriers are stifling innovation and adding costs to providers developing new products.

That said, if people have not saved sufficiently during their working lives, they are unlikely to achieve their objectives in retirement with any combination of products.

### The range of products

Mercer's submission notes that the "major shortcoming [of the Australian superannuation system] is in respect of the availability of a broad range of post retirement products that meets the risks faced by retirees".<sup>55</sup> If the goal is to increase the use of products with longevity protection, Australia needs to have an appropriate and affordable range of products.<sup>56</sup>

Two examples of products that could be useful to retirees are described below.

#### *Deferred lifetime annuities*

Deferred lifetime annuities (DLAs) are a form of lifetime annuity where income payments are delayed for a set amount of time. For example, a 65-year-old retiree may purchase a DLA that will provide a steady income stream after the retiree turns 85 and guarantee an income above that of the Age Pension for the remainder of the retiree's life.

From the provider's perspective, DLAs insure the most risky period of a standard lifetime annuity. They require significant capital to manage risk. The income efficiency of DLAs cannot be estimated because demand for the product is very low in Australia, although they are likely to be less efficient than standard lifetime annuities. However, DLAs may be attractive to retirees because the commitment of funds for a given income stream declines with the length of deferral. There may be a death benefit payable if the annuitant dies before payments begin, but this benefit would increase the cost of a DLA.

DLAs could be used to complement account-based pensions. Account-based pensions are more income-efficient when drawn down at a faster-than-minimum rate.<sup>57</sup>

Drawdowns can be structured so that the balance is exhausted, or close to exhausted, at the time a DLA begins to make payments.

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<sup>55</sup> Mercer 2014, First round submission to the Financial System Inquiry, page 1.

<sup>56</sup> Superannuation funds cannot *directly* provide guaranteed products (life insurance companies can). Superannuation funds are able to provide account-based pensions, and would be able to provide GSAs.

<sup>57</sup> That is, the expected present value of income in retirement is higher.

### *Group self-annuitisation*

In a group self-annuitisation (GSA), participants contribute funds to a pool that is invested in financial assets. Regular payments from the pool are made to surviving members. Pooling mortality risk delivers higher income in retirement than an account-based pension that is drawn down at the minimum rate, while also providing significantly more protection against longevity risk. GSAs allow pool members to share, but not completely eliminate, longevity risk and do not require capital to back guarantees. They can also be offered on a deferred basis like a DLA.

GSA income is not guaranteed like annuity income, but it is expected to be higher due to the absence of capital requirements to back guarantees. The efficiency of the product is 100 per cent (excluding any administrative costs) as the entirety of a pool member's contribution is expected to be paid as income. Income levels may be lower at older ages if, for example, the entire pool lives longer than expected. Members also lose flexible access to capital and are unable to bequeath residual assets.

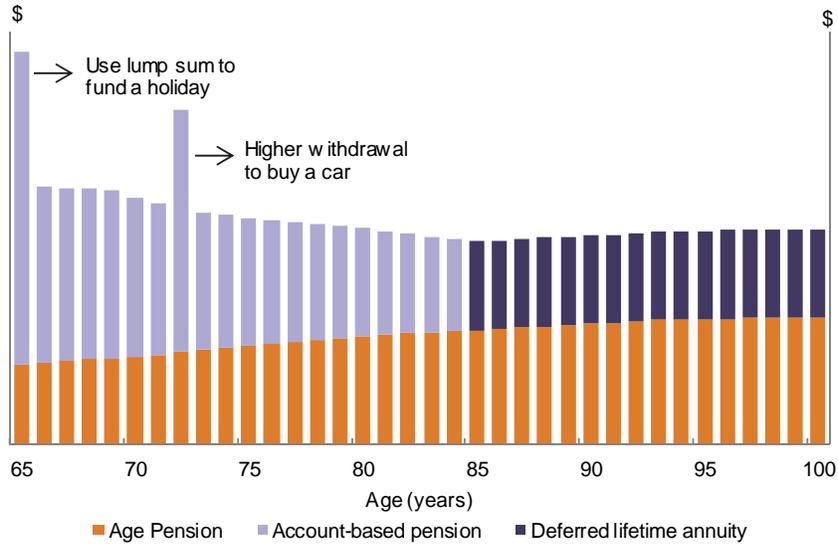
Singapore's Central Provident Fund Lifelong Income For the Elderly (CPF LIFE) scheme has some characteristics of a GSA. Participation is mandatory for those with retirement account balances above a minimum level. Members choose between two plans: one pays a higher income but leaves less for bequests, the other pays a lower income but leaves more for bequests. Payments are not guaranteed to be constant but are designed to be relatively stable; they are adjusted to reflect actual investment returns and mortality.

Other products with longevity risk management features might also emerge if policy settings are changed.

### *A portfolio of products*

Given the different income, risk management and flexibility characteristics of products, retirees with sufficient savings will typically best meet their objectives by using a combination of products and taking some of their benefits as a lump sum. One option, but not the only option, is for an individual to invest a portion of their accumulated funds in a DLA to manage longevity risk. The remainder could be placed in an account-based pension to provide the flexibility to meet unforeseen expenditure needs and offer the potential to deliver higher investment returns (Chart 8.6).

**Chart 8.6: Stylised example of annual income for a retiree with multiple income products**



## Regulatory barriers to product development

### *SIS regulations*

For retirees aged 60 years or older, investment earnings on superannuation assets that support eligible income stream products are exempt from tax. Eligible income stream products must comply with the standards in the Superannuation Industry (Supervision) Regulations 1994 (SIS Regulations). These standards are designed to accommodate products that provide retirement incomes.<sup>58</sup>

Several submissions suggest that the rules are too inflexible to allow innovation and new products. Neither DLAs nor GSAs meet the standards set out in the SIS Regulations. In practice, if a product cannot qualify for a tax exemption, the market for that product is highly unlikely to develop. Many submissions call for removing the barriers to product innovation imposed by the SIS Regulations.

<sup>58</sup> For account-based pensions, the rules specify that a minimum amount must be paid from the product each year. Other products must meet a prescriptive set of requirements including payments at least annually (which disqualifies DLAs), and restrictions on variations in annual payments (which disqualify GSAs).

Australia's Future Tax System Review also recommended removing these rules, in conjunction with taxing superannuation assets in both the accumulation and retirement phases at a uniform rate.<sup>59</sup>

### *Age Pension means-tests*

The Age Pension assets test and income test (through deeming an income on assets) apply to DLAs, even during the deferral period. Several submissions call for an exemption for non-commutable DLAs from the tests during the deferral period. Australia's Future Tax System Review recommended "given the unique nature of deferred annuities, there is a case that they should only be means tested when they start to pay an income, unless a person can access the capital before this time".<sup>60</sup>

### *Multiple approvals required*

Tax and social security settings are major factors affecting demand for retirement income products, as noted above. Providers of new retirement income products must deal with multiple Government bodies for approvals, including the ATO, APRA, ASIC and the Department of Social Services.

### *Risk management for product providers*

Longevity risk cannot be eliminated. It can only be transferred. The burden of managing longevity risk must fall on individuals, pools, insurers or government.

Providers of guaranteed retirement income products, especially long-dated or whole-of-life products, are exposed to interest rate, investment and longevity risk. Mitigating these risks requires using more capital, obtaining reinsurance, or managing them in financial markets, for example, by taking offsetting positions in bond or derivative markets. Due to the long-tailed nature of these risks, capital requirements are high, which increases the price of the products. The lack of very long-dated bonds and longevity bonds in wholesale markets makes it difficult to transfer that risk in financial markets.

Unpredictable systematic longevity improvement, potentially brought about by medical advancements, provides significant uncertainty around future longevity. This explains why capital charges on annuities are high, reinsurers are reluctant to take on the risk and there are no issuers of longevity bonds. If a medical breakthrough were to increase life expectancies substantially, longevity insurance providers could be put under financial pressure. It might be appropriate that only prudentially regulated life insurance companies be allowed to provide guaranteed products.

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<sup>59</sup> Commonwealth of Australia 2009, *Australia's Future Tax System Review, Report to the Treasurer, Part Two, Detailed analysis, volume 1 of 2*, Canberra.

<sup>60</sup> Ibid.

Providers have extremely long-dated liabilities and could more efficiently manage the resulting interest rate risk by investing in (say) 30-year Government bonds. In recent years, the risk-free Commonwealth Government yield curves (both nominal and inflation-linked) have been lengthened, but only to around 20 years. In part, this is because of limited investor demand for bonds with very long tenors. Several submissions call for the Government to issue longer dated bonds to facilitate interest rate risk management for retirement income product providers. Long-dated government bonds would also support the private provision of longevity bonds.<sup>61</sup>

Challenger's submission notes that capital requirements for Australian life insurance companies offering annuities are high by international standards.<sup>62</sup> This provides greater assurance to recipients against the failure of the provider. However, it also makes annuities more expensive.

### *Government provision*

If, after removing barriers to market development, the financial system cannot develop a market to manage longevity risk effectively, there may be a case for Government intervention.

The Government could offer longevity insurance to individuals on a commercial basis, in addition to that provided by the Age Pension. For example, this could take the form of a premium paid at retirement, invested outside the consolidated revenue fund — potentially by the Future Fund Board of Guardians — and used to fund an income stream from age 85.

Australia's Future Tax System Review recommended:

*The government should consider offering an immediate annuity and deferred annuity product that would allow a person to purchase a lifetime income. This should be subject to a business case that ensures the accurate pricing of the risks being taken on by the government. To limit the government's exposure to longevity risk, it should consider placing limits on how much income a person can purchase from the government.*<sup>63</sup>

However, this policy option would increase the Government's already significant exposure to longevity risk. This risk would be mitigated if the Government offered a non-guaranteed GSA-type product. Alternatively, the Government could charge an appropriate price for the extra risk it took on.

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61 Wills, S and Sherris, M 2010, 'Securitization, Structuring and Pricing of Longevity Risk', *Insurance: Mathematics and Economics*, vol 46, issue 1, Elsevier, London, pages 173–185.

62 Challenger 2014, First round submission to the Financial System Inquiry, page 22.

63 Commonwealth of Australia 2009, *Australia's Future Tax System Review, Report to the Treasurer, Part Two, Detailed analysis, volume 1 of 2*, Canberra.

## Policy options for consultation

Removing barriers to product development may allow innovation in retirement income products. UniSuper's submission notes: "Government regulation over the past 20 years has had as much, if not more, influence on product design than industry-led ideas".<sup>64</sup>

One policy option proposed in submissions is to streamline administrative arrangements for assessing the eligibility of products for tax concessions and Age Pension means-test treatment. This may reduce the regulatory costs of product development.

Government could facilitate long-dated interest rate risk management for retirement income product providers and support the private provision of longevity bonds by issuing long-dated Treasury Bonds and Treasury Indexed Bonds – with payments linked to inflation. As long-term interest rates are typically higher than short-term interest rates, there may be a cost to Government of maintaining a longer yield curve. Given its current size, the longevity product market may not be able to 'digest' a significant supply of long-dated bonds. These costs would depend on the volume of long bonds issued and market conditions.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-tests.
- For product providers, streamline administrative arrangements for assessing the eligibility for tax concessions and Age Pension means-tests treatment of retirement income products.
- Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products.

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<sup>64</sup> Unisuper 2014, First round submission to the Financial System Inquiry, page 6.

*The Inquiry seeks further information on the following areas:*

- Would deferred lifetime annuities or group self-annuitisation be useful products for Australian retirees? Are there examples of other potentially suitable products?
- If part of retirees' superannuation benefits were to default into an income stream product, which product(s) would be appropriate?
- Will the private sector be able to manage longevity risk if there is a large increase in the use of longevity-protected products? How could this be achieved?
- Should Government increase its provision of longevity insurance? How would institutional arrangements be established to ensure they were stable and not subject to political interference?
- What are some appropriate ways to assess and compare retirement income products? Is 'income efficiency' a useful measure?

## Access to equity in the home

For many retirees, the family home is their most valuable asset. Equity release products allow consumers to access the equity of a property while retaining ownership. The most common forms of equity release are reverse mortgages and home reversion schemes.<sup>65</sup> A number of submissions note the potential benefits to retirees of a growing market for these products.

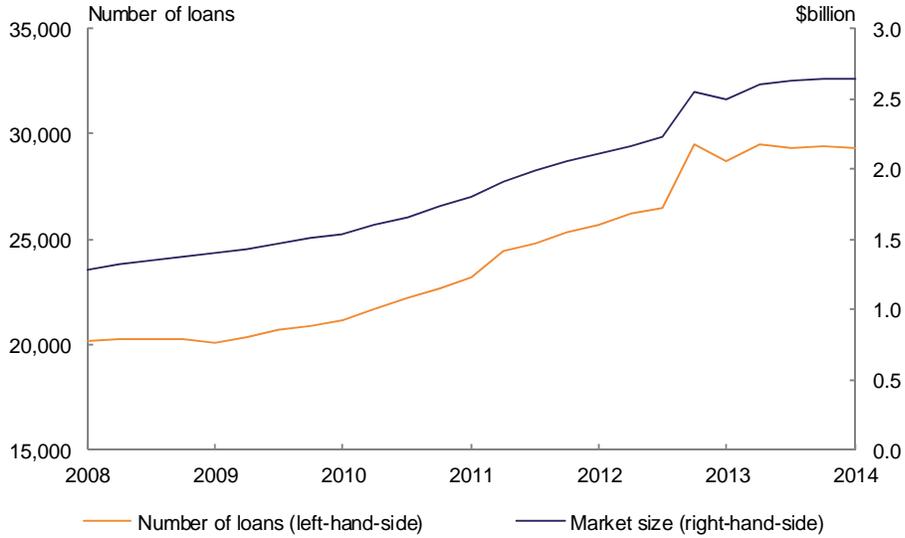
The reverse mortgage market has grown steadily (Chart 8.7). However, fewer than five lenders currently offer the product, compared to more than 15 lenders before the GFC.<sup>66</sup>

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<sup>65</sup> A reverse mortgage is a credit product that allows a person to borrow money against the equity in the home in return for a lump sum, line of credit or regular payment. A home reversion scheme allows a consumer to sell a portion of their home in exchange for a fixed proportion of the proceeds of the home when it is sold.

<sup>66</sup> Deloitte and SEQUAL 2013, Australia's equity release market — an opportunity being missed, media release, 16 September, viewed 17 June 2013, <[http://www.deloitte.com/view/en\\_au/au/8a7f3ecfae321410VgnVCM3000003456f70aRCRD.htm](http://www.deloitte.com/view/en_au/au/8a7f3ecfae321410VgnVCM3000003456f70aRCRD.htm)>.

**Chart 8.7: Reverse mortgages provided by ADIs**



Source: APRA.<sup>67</sup>

One issue with releasing home equity is that an individual may later have insufficient equity to fund an accommodation bond for an aged care facility.

The small size of the current market appears to reflect individual preferences and commercial considerations. The market is expected to grow further as the population ages, given the large amount of wealth tied up in dwellings.

*The Inquiry seeks further information on the following area:*

- What, if any, regulations impede the development of products to help retirees access the equity in their homes?

<sup>67</sup> Australian Prudential Regulation Authority 2014, Quarterly Authorised Deposit-taking Institution Property Exposures, Sydney, March. Includes ADIs with greater than \$1 billion of term loans.



## 9: Technology

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Technology is a powerful force for change in the financial system, potentially improving efficiency and competition, and benefiting consumers. Consumers have better access to information and products to meet their needs. Firms can better customise products and enhance internal processes. Competition is emerging from technology-enabled alternative business models, new entrants and new services.

Financial services boundaries are shifting as firms from inside and outside the sector harness the power of data to create and capture value in new ways. In particular, many are seeking to influence a greater share of consumers' spending. Increasingly, technology firms and retail groups are also becoming part of financial service delivery. These trends and benefits bring new or intensified risks.

The Inquiry has made the following observations about technology in the Australian financial system:

- Technological innovation is a major driver of efficiency in the financial system and can benefit consumers. Government and regulators need to balance these benefits against the risks, as they seek to manage the flexibility of regulatory frameworks and the regulatory perimeter. Government is also well-positioned to facilitate innovation through coordinated action, regulatory flexibility and forward-looking mechanisms.
- Access to growing amounts of customer information and new ways of using it have the potential to improve efficiency and competition, and present opportunities to empower consumers. However, evidence indicates these trends heighten privacy and data security risks.
- The financial system's shift to an increasingly online environment heightens cyber security risks and the need to improve digital identity solutions. Government has the ability to facilitate industry coordination and innovation in these areas.

## Context

### Changing consumer attitudes and behaviours

Technological innovations are changing the products and services Australians buy, how they buy them, who they buy them from, and who they entrust with their information. The internet is Australia's most popular form of media, having overtaken television consumption in 2007. Currently, 83 per cent of Australian households have internet access at home,<sup>1</sup> compared to only 14 per cent<sup>2</sup> at the time of the Wallis Inquiry; 10.8 million Australians now access the internet more than once a day; and 7.5 million accessed the internet via their mobile phones in 2013, an increase of 33 per cent from 2012.<sup>3</sup>

The uptake rate for smartphones in Australia is among the highest in developed economies: 84 per cent of Australian mobile phone users have smartphones, a meteoric rise from a base of 19 per cent in 2007.<sup>4</sup> More than 5 million Australians now have tablets, with penetration expected to rise to 70 per cent of the population by 2017.<sup>5</sup>

Social media is increasing both the pressure on financial service providers to be responsive to consumer demands and the reputational risks of failing to do so. Increasingly, consumers trust reviews and recommendations on social networking sites from people they know over information sourced from manufacturers and retailers, third-party sites, in-store salespeople or advertising.<sup>6</sup>

These trends are changing the ways Australians work, manage their finances, communicate, learn and access entertainment — and setting new standards for customer service. Increasingly, consumers expect online services to be personalised,

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1 Australian Bureau of Statistics (ABS) 2014, *Household Use of Information Technology, 2012-13*, cat. no. 8146.0, ABS, Canberra.

2 Australian Bureau of Statistics (ABS) 1998, *Household Use of Information Technology, 1997*, cat. no. 8146.0, ABS, Canberra.

3 Australian Communications and Media Authority (ACMA) 2013, *Communications report 2012-13*, ACMA, Melbourne.

4 Luger, J 2013, 'The massive Australian mobile explosion explained', *Business Insider Australia*, 9 July, viewed 1 May 2014, <<http://www.businessinsider.com.au/the-massive-australian-mobile-explosion-explained-2013-7>>.

5 Research by Telsyte cited in Moses, A 2013, 'Tablets to reach 70% of Australians by 2017', *Sydney Morning Herald*, 13 March, viewed 2 July 2014, <<http://www.smh.com.au/digital-life/digital-life-news/tablets-to-reach-70-of-australians-by-2017-20130312-2fz9o.html>>.

6 The Boston Consulting Group (BCG) 2013, *2013 Global Consumer Sentiment Survey*, BCG.

interactive and engaging, available 24/7 and continuously improving. Self-service options, securely handled personal data, and speedy and reliable payments are a given.<sup>7</sup>

More Australians shop online for insurance and financial services than their counterparts in the United States and major European Union economies.<sup>8</sup> Of online Australians, almost all have compared and purchased products or services online, while more than two-thirds have used online comparison services. The main reasons cited for using these services were to obtain lower prices, save time and enable easier comparison for better-informed purchasing decisions.<sup>9</sup>

### Retail banking and payments

These trends are fundamentally changing the way financial institutions interact with their customers. For instance, in banking, large segments of the population are shifting away from face-to-face services to online and mobile banking. Online and electronic banking applications (apps) are emerging as an important area of competition and product differentiation.

Banks have increasing numbers of customers choosing to use apps rather than other online channels. For example, Westpac has more than 45 apps across its brands, designed for different technology platforms and devices.<sup>10</sup> Banks are also starting to provide smart automated teller machines (ATMs) that offer customers more self-service options, along with real-time online 'chat' services.

Increasingly, Australians use the internet and apps to conduct banking rather than visit branches. In 2013, 12.9 million Australians used the internet for banking and paying bills, a rise of 10 per cent from the year before.<sup>11</sup> Although person-to-person contact in branches remains important, it is primarily becoming the domain of more complex transactions. By the end of 2015, following a gradual decline in the average number of transactions per branch, ANZ expects digital will be its customers' preferred channel.<sup>12</sup>

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7 IBM Institute for Business Value 2014, *Digital reinvention: Trust, transparency and technology in the insurance world of tomorrow*, IBM Global Business Services, January, Somers.

8 The Boston Consulting Group (BCG) 2013, *2013 Global Consumer Sentiment Survey*, BCG.

9 Research by Nielsen cited in iSelect Limited 2013, *Prospectus: For the offer of 116.4 million shares in iSelect Limited at \$1.85 per share*, May, viewed 30 April 2014, <<http://corporate.iselect.com.au/wp-content/uploads/2013/09/4-June-2013-Prospectus.pdf>>.

10 Westpac 2014, First round submission to the Financial System Inquiry.

11 Australian Communications and Media Authority (ACMA) 2013, *Communications report 2012-13*, ACMA, Melbourne.

12 ANZ 2014, First round submission to the Financial System Inquiry.

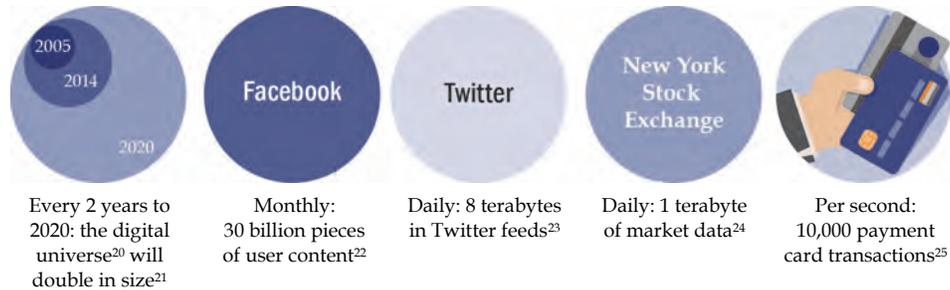
Contactless near-field communications (NFC) payments are growing rapidly, driven mainly by the speed of the transaction.<sup>13</sup> NFC payments are made by tapping contactless cards or smartphones with embedded technology or smart stickers attached against terminals.<sup>14</sup> In Australia, Visa now processes more than 28 million contactless payments per month, across more than 100,000 contactless terminals.<sup>15</sup>

As digital banking has become widespread, security has improved commensurately, with measures such as the shift to EMV<sup>16</sup> chip-based cards making it almost impossible to skim or counterfeit cards.<sup>17</sup> The planned move to PIN-only verification is also expected to improve security.<sup>18</sup> However, some suggest that the growth of NFC payments is resulting in a return to older forms of fraud, such as card theft.<sup>19</sup>

## Value of information

Growing amounts of structured and unstructured data are being collected, stored and used by private sector firms and governments, a phenomenon known as ‘big data’. Firms increasingly seek to extract value from these vast stores of data through information analytics to create and capture value in new ways. In particular, many are seeking to influence a greater share of consumers’ spending.

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- 13 Ossolinski, C, Lam, T and Emery, D 2014, *The Changing Way We Pay: Trends in Consumer Payments – Research Discussion Paper*, Reserve Bank of Australia, Sydney.
  - 14 Bender, A 2014, ‘Mobile Payments in Australia: State of the Banks’, *Computerworld*, 29 January.
  - 15 Elsworth, S 2014, ‘Australia hooked on tap and go payments: Visa payWave’, News Corp Australia Network, 9 February, viewed 6 May 2014, <<http://www.news.com.au/finance/money/australia-hooked-on-tap-and-go-payments-visa-paywave/story-e6frfmci-1226821426268>>.
  - 16 Europay, MasterCard and Visa
  - 17 Drummond, S 2014, ‘Top cyber cop warns over bank cards threat’, *The Australian Financial Review*, 30 May.
  - 18 PIN-only verification comes into effect in Australia on 1 August 2014. See Australian Associated Press 2014, ‘PIN-only purchases as credit card signatures to be phased out’, *The Australian*, 22 January.
  - 19 Donnelly, B 2014, ‘Consumers told to check tap-and-go transactions as deception cases increase’, *Sydney Morning Herald*, 28 May.

**Figure 9.1: Examples of growth in data volumes**

With no physical products to manufacture and large existing repositories of consumer information, financial services firms are well placed to benefit from big data. In a 2012 IDC survey, 71 per cent of financial services firms viewed information analytics as a potential source of competitive advantage for their organisations.<sup>26</sup>

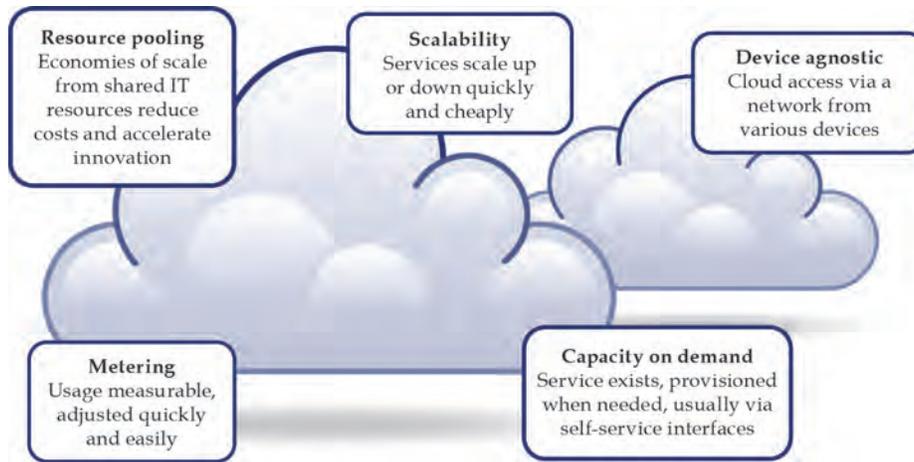
## Cloud technology

Firms are increasingly using cloud computing solutions to improve the efficiency, flexibility and availability of systems. The term ‘cloud’ refers to a delivery model rather than a particular technology. Cloud services use virtualisation and network technologies to enable sharing of hardware, software and databases, either singularly or in combination. Typically, delivery relies on the internet and uses the services of third-party providers.

Figure 9.2<sup>27</sup> below shows the characteristics of cloud computing that make it so attractive to both private and public sector organisations.

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- 20 Defined by IDC as all digital data created, replicated and consumed in a single year. See Gantz, J and Reinsel, D 2012, *The Digital Universe in 2020: Big Data, Bigger Digital Shadows, and Biggest Growth in the Far East*, IDC iView, December, viewed 22 May 2014, <<http://www.emc.com/collateral/analyst-reports/idc-the-digital-universe-in-2020.pdf>>.
- 21 Gantz, J and Reinsel, D, IDC iView.
- 22 Versace, M and Massey, K 2012, *The Case for Big Data in the Financial Services Industry – White Paper*, IDC Financial Insights, September, viewed 22 May 2014, <<http://h20195.www2.hp.com/V2/GetPDF.aspx%2F4AA4-3900ENW.pdf>>.
- 23 Versace, M and Massey, K, IDC Financial Insights.
- 24 Versace, M and Massey, K, IDC Financial Insights.
- 25 Versace, M and Massey, K, IDC Financial Insights.
- 26 IBM Institute for Business Value 2013, *Analytics: The real-world use of big data in financial services – How innovative banking and financial markets organizations extract value from uncertain data*, IBM Global Business Services, May, Somers.
- 27 Department of Broadband, Communications and the Digital Economy (DBCDE) 2013, *The National Cloud Computing Strategy*, DBCDE, Canberra.

**Figure 9.2: Characteristics of cloud computing**



In Australia, cloud services revenue is projected to grow at a compound annual rate of 15.3 per cent from 2012 to 2017.<sup>28</sup> Globally, two-thirds of banks expect their IT infrastructure expenditure to grow by between 1 and 6 per cent in 2014, driven primarily by cloud computing investments.<sup>29</sup>

Personal cloud service usage is also growing in Australia, as a result of increasing network capacity and individuals using multiple devices to access the internet. In 2013, 14 million Australians used personal cloud services — including for email and social networking — an increase of 11 per cent on 2012 figures.<sup>30</sup>

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28 Gartner research cited in Bajric, N 2013, 'Cloud to become bulk of new IT spend by 2016: Gartner', *ARN*, 25 October, viewed 16 April 2014, <[http://www.arnnet.com.au/article/530054/cloud\\_become\\_bulk\\_new\\_it\\_spend\\_by\\_2016\\_gartner/](http://www.arnnet.com.au/article/530054/cloud_become_bulk_new_it_spend_by_2016_gartner/)>.

29 Research by Ovum cited in Pinsent Masons 2013, 'Need for regulatory compliance to drive 2014 increase in IT expenditure in financial services sector, predicts Ovum', *Out-Law.com*, 16 December, viewed 23 May 2014, <<http://www.out-law.com/en/articles/2013/december/need-for-regulatory-compliance-to-drive-2014-increase-in-it-expenditure-in-financial-services-sector-predicts-ovum/>>.

30 Australian Communications and Media Authority (ACMA) 2013, *Communications report 2012–13*, ACMA, Melbourne.

## Regulation in a digital environment

### *Observation*

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

## Technology neutrality

Government and regulators face ongoing challenges from the need to apply existing regulatory frameworks to new participants and products in a rapidly changing environment.

### Preliminary assessment

Some Federal and state-based legislation and regulations require (implicitly or explicitly) the use of certain forms of technology. For example, they may specify certain delivery mechanisms or products, or use terminology that assumes a paper-based environment. That is, they are not technology neutral. In other cases, new technologies put in doubt the operation of certain provisions of legislation or regulations. These circumstances can prevent the uptake of new technologies that could provide better outcomes for consumers, businesses and Government. They can also prevent Government and regulators from managing risks appropriately.

Submissions suggest Government should aim to enable transactions and business to be carried out digitally end-to-end: regulation should not make it more difficult and expensive to conduct business through purely digital channels. Submissions mainly focus on the need to update disclosure and consent requirements to reflect both changing consumer preferences and the emergence of new technologies.

Stakeholders identified various requirements, conceived in a paper-based era, that are not technology neutral and may restrict digital services. For example, at the Federal level, both Chapter 7 of the *Corporations Act 2001* and the *National Consumer Credit Protection Act 2009* set out requirements for Financial Services Guides as to what must be on the “cover” or “at or near the front of” the “document”.<sup>31</sup> At the state level, the Victorian *Transfer of Land Act 1958* enables use of an electronic lodgement network for

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<sup>31</sup> Refer, for example, to ss942A(1) and 942D(2) of the *Corporations Act 2001*.

e-conveyancing. However, it contains requirements for retaining physical documents to authenticate electronic instruments,<sup>32</sup> as well as requirements such as signature authorisation of instruments in writing.<sup>33</sup>

Government has taken some steps to better enable digital services, with amendments set out in the *Electronic Transactions Act 1999*. The Australian Securities and Investments Commission (ASIC) has also facilitated online financial services disclosures through its relief powers, as described in *Regulatory Guide 221*.<sup>34</sup> However, not all issues have been addressed. One submission highlights the *Electronic Transactions Regulations 2000* themselves are unclear on the form of customer consent required before documents can be sent out electronically.<sup>35</sup>

Submissions also note that, where changes in technology create difficulties in interpreting provisions, firms are likely to take a conservative view to minimise regulatory compliance risks. Consequently, they may be reluctant to change and improve systems or processes.

Legislators and regulators cannot anticipate all the new products and delivery mechanisms technology might enable. For example, s12DL of the *Australian Securities and Investments Commission Act 2001* prohibits credit card issuers from sending out unsolicited cards. This provision was initially developed in 1975 to address the growth in unsolicited credit cards at the time.<sup>36</sup> However, since then, many new developments in payments have brought the application of s12DL into doubt. For instance, today providers do not have to send a physical card to provide unsolicited access to credit accounts – they can simply provide NFC stickers or leverage mobile phone technologies.

At the time s12DL was first drafted, these dramatic changes could not have been foreseen, making it impossible to design amendments to address likely developments. Therefore, where possible, future legislation and regulation should aim to be technology neutral. Sometimes, technology-specific requirements may be necessary; for example, the voluntary Electronic Funds Transfer Code of Conduct (EFT Code), now the ePayments Code, was developed to assist with consumer confidence and

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32 Refer, for example, to s44B(2)(b) of the *Transfer of Land Act 1958 (VIC)*.

33 Refer, for example, to s44C(b) of the *Transfer of Land Act 1958 (VIC)*.

34 Australian Securities and Investments Commission (ASIC) 2010, *Regulatory Guide 221: Facilitating online financial services disclosures*, ASIC, December.

35 For example, the regulations refer to the debtor, mortgagor or guarantor providing 'written consent' to receiving communications electronically.

36 Australian Securities and Investments Commission (ASIC) 2014, First round submission to the Financial System Inquiry.

uptake of non-cash payments.<sup>37</sup> However, these should be the exception rather than the norm.

### *Trade-offs*

In pursuing technology neutrality, Government needs to consider the text of legislation and regulation, as well as the approach of regulators. Technology neutrality in regulation can provide flexibility to adapt to the future and reduce the need for constant change. However, it can also result in ambiguity and interpretation difficulties. For example, the definitions of ‘financial product’ and ‘financial service’ under the *Corporations Act 2001* are designed to be broad, technology neutral and applicable to different business models. Consequently, although the law applies widely, ASIC also regularly has to deal with questions of interpretation – and often issues regulatory exemptions for certain classes of products.

Amending existing regulation and legislation requires significant Government and regulatory resources, and aiming for technology neutrality can be challenging. Frameworks often contain unintentional biases, which are only identified in hindsight. Lengthy regulatory processes can also create uncertainty for industry during the transition period. Yet, lack of consultation or rushed processes increase the risk of unintended consequences. However, failing to act may mean consumers, businesses and Government lose the benefits of potential innovation and competition.

A number of submissions also highlight that, although enabling electronic service delivery might improve efficiency and outcomes for some consumers, it may also exclude others. For example, various community segments such as senior Australians<sup>38</sup> or those on lower incomes may have more limited ability to access the internet.<sup>39</sup> As a result, they may be excluded in an environment where electronic service delivery is the default. Some of these issues may diminish over time; nonetheless, access issues must be carefully considered and managed – particularly through any transition period.

## Policy options for consultation

### *Existing regulation*

Existing regulation and legislation should be reviewed to amend references that are not technology neutral. Regulatory settings should enable electronic service delivery to

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37 Australian Securities and Investments Commission (ASIC) 2011, 11-205MR ASIC releases new ePayments Code, media release 20 September, Sydney.

38 Research by the Australian Communications and Media Authority cited in Joint Select Committee on Cyber-Safety 2013, *Cybersafety for Seniors: A Worthwhile Journey – Second Interim Report*, Parliament of the Commonwealth of Australia, March, Canberra.

39 Australian Bureau of Statistics (ABS) 2014, *Household Use of Information Technology, 2012–13*, cat. no. 8146.0, ABS, Canberra.

become the default; however, opt-out provisions are required to manage access needs for certain community segments.

For example, amendments could include removing references to specific forms of payment. They could include updates to consumer disclosure requirements and methods of consumer consent to accommodate electronic delivery, digital signatures or voice authentication. Where the text of legislation has been put in doubt by new technologies, it could also be updated to clarify interpretation.

### *Future regulation*

In preparing for future developments, Government and regulators should take a technology-neutral approach to legislation and regulation. On an exceptions basis, technology-neutral frameworks may need to be supplemented with technology-specific regulation. For example, this might include situations where certain technologies introduce new risks requiring specific protections, such as the circumstances surrounding the introduction of the ePayments Code.<sup>40</sup>

When technology-specific regulation is required, regulators should seek to be technology neutral within that class of technologies where possible. For example, in dealing with non-cash payments, regulation should not seek to favour one form of non-cash payment, such as credit cards, over another, such as direct debit.

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- No change to current arrangements.
- Amend regulation that specifies using certain technologies with the aim of becoming technology neutral. Amendments should enable electronic service delivery to become the default; however, they should include opt-out provisions to manage access needs for segments of the community.
- Adopt a principle of technology neutrality, for future regulation recognising the need for technology-specific regulation on an exceptions basis. Where technology-specific regulation is required, seek to be technology neutral within that class of technologies.

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<sup>40</sup> Australian Securities and Investments Commission (ASIC) 2011, 11-205MR ASIC releases new ePayments Code, media release 20 September, Sydney.

*The Inquiry seeks further information on the following area:*

- What specific regulatory and legislative requirements should be prioritised for amendment in relation to technology neutrality?

## Regulatory perimeter

Technological innovation has enabled firms outside the traditional financial sector to perform financial-type functions. Some of these firms may not be regulated at all or regulated in a different way to financial institutions. This raises challenges for the regulatory perimeter, in terms of whether certain risks are being addressed appropriately by firms and regulators. It also potentially raises level playing field issues, where firms may be performing similar functions but not being regulated equivalently. Developments in payments exemplify these issues.

## Preliminary assessment

Advances in technology have reduced traditional barriers to market entry in payments, such as the need to construct a dedicated network. New entrants can leverage high levels of internet connectivity, penetration of smart devices and pre-existing networks to connect users to payments services more easily and cheaply than incumbents. The payment hub, being developed by eftpos Payments Australia Limited, and the New Payments Platform (NPP), an industry project being developed as a result of the Reserve Bank of Australia's (RBA's) strategic innovation review, may further reduce barriers to entry and drive competition.

Incumbents in the Australian payments industry are facing competitive challenges from new market entrants, such as PayPal, POLi, PayMate and Stripe. Closed-loop pre-paid systems operated by companies outside the financial sector, such as Apple, Skype and Starbucks, are holding growing amounts of customers' funds. Apple has also recently signalled its interest in mobile payments more broadly and recently developed fingerprint biometric authentication for its phones.<sup>41</sup>

Advances in cryptography<sup>42</sup> and computer processing power have facilitated the development of virtual or crypto-currencies.<sup>43</sup> A number of submissions note the potential risks these technologies present to the financial system:

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41 Edwards, J 2014, 'Apple Is Building Its Next Massive Business And No One Seems To Have Noticed', *Business Insider Australia*, 23 February, viewed 10 April 2014, <<http://www.businessinsider.com.au/apple-ecommerce-and-mobile-payments-plans-2014-2>>.

42 Cryptography refers to techniques for securing communications from third-party access.

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- The **safety** of funds stored in them may be at risk in the case of system collapse or fraud, which may also occur in a third-party provider associated with the virtual currency. For example, in the recent collapse of the Mt Gox bitcoin exchange, 850,000 bitcoins worth approximately US\$474 million were lost.<sup>44</sup>
- The **highly speculative** nature of virtual currencies may create investor protection issues, as demonstrated by bitcoin's fluctuating values in relation to real-world currencies.<sup>45</sup>
- The **pseudonymity** of payments makes them attractive for money laundering and other illegal activities.
- Their **cross-jurisdictional** nature means coverage under any particular legal jurisdiction is unclear. Currently, use of virtual currencies in Australia is minimal, but regulators are monitoring developments in this area.

Some submissions argue that firms performing similar functions should be regulated in the same way. This position is often made by large incumbent players concerned about the capacity of new players to operate around the edge of the regulatory perimeter. Failure to apply equivalent regulation may result in an uneven playing field and regulatory arbitrage. It may also incentivise those within the current regulatory perimeter to lower their own standards of compliance to compete. However, applying the full weight of prudential or conduct regulation to small players and new start-ups, regardless of the materiality of the risk they represent, may stifle valuable innovation unnecessarily.

### Policy options for consultation

Whether new entrants should be brought within a regulatory perimeter depends on the nature and scale of the risk they present and who bears the risk. Government needs to strike a balance that allows the benefits of innovation to flow through the financial system, while maintaining stability.

The *Regulatory architecture* chapter contains broader discussion of options for the regulatory perimeter.

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43 Elwell, C K, Murphy M M and Seitzinger, M V 2013, *Bitcoin: Questions, Answers, and Analysis of Legal Issues*, US Congressional Research Service, Washington, 20 December.

44 Hornyak, T and Kirk, J 2014, '10 things you need to know about Mt. Gox's Bitcoin implosion', *PCWorld*, 6 March.

45 Colombo, J 2013, 'Bitcoin may be following this classic bubble stages chart', *Forbes*, 19 December.

## Facilitating innovation

Technological innovation has the potential to improve financial system efficiency. It is a powerful force for competition, driving the development of products that better meet consumer needs and improve access. Firms can harness technologies to improve risk management and other internal processes. Although innovation has many benefits, it may also bring risks. Government must manage these risks, while enabling the benefits of innovation to flow through the system.

Many technological developments adopted by financial institutions start life outside the sector. For example, while banking apps have proliferated in recent years, early apps were typically video games or basic functions such as calendars.<sup>46</sup> In many ways, this pattern of taking up new, but tested, technologies benefits the sector: it lowers the risk of innovation, while taking advantage of its benefits.

### Preliminary assessment

#### *Coordinated action*

Government can play a role in facilitating technological innovation where there is a need to overcome divergent commercial interests and competitive forces. This is particularly the case where network benefits are involved. Government can assist industry to agree on standards for interoperability or to cooperate on developing common infrastructure.

For example, the RBA has facilitated industry cooperation to develop a real-time payments system: the NPP. The RBA's strategic review of innovation in the payments system concluded that market forces were not sufficient on their own to produce cooperative innovation.<sup>47</sup> This became evident when previous industry-initiated projects, such as MAMBO (Me and My Bank Online) intended to enable a wider range of payments, were abandoned due to rising costs, ongoing delays and differing commercial interests of the major banks.<sup>48</sup> The NPP will provide basic common infrastructure that industry can build on to provide innovative customer-facing services. The project is expected to be completed in late 2016.<sup>49</sup>

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46 Clark, J F, 'History of mobile applications', Presentation for MAS 490: Theory and practice of mobile applications, University of Kentucky, viewed 16 June 2014, <<http://www.uky.edu/~jclark/mas490apps/History%20of%20Mobile%20Apps.pdf>>.

47 Reserve Bank of Australia (RBA) 2012, *Strategic Review of Innovation in the Payments System: Conclusions*, RBA, Sydney.

48 Australian Associated Press 2011, 'Banks axe BPAY identity project', *Sydney Morning Herald*, 26 August.

49 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry.

Submissions raise other areas where Government could play a similar facilitation role. For example, one submission suggests Government could help coordinate development of a central utility to streamline superannuation administrative processes.<sup>50</sup> Others suggest Government could assist with streamlining processes for online identity authentication. This is discussed further in the *Digital identity* section.

### *Regulatory flexibility*

Government and regulators face challenges from the expected pace of change in technological developments. By its nature, regulation lags market developments. Consequently, Government and regulators need effective mechanisms for monitoring emerging trends, a flexible approach, and the ability to adapt and design regulation in a changing environment.

Where new, technology-enabled business models, products and delivery mechanisms emerge, regulators need to consider whether and how to regulate such developments. They may also need to be flexible in how they apply existing frameworks. For example, to enable industry innovation and competition, ASIC has provided relief to operators of investor-direct portfolio services (IDPS) and IDPS-like schemes (known as ‘platforms’ or ‘wraps’) from the legal requirements for managed investment schemes.<sup>51</sup> The Corporations and Markets Advisory Committee recently released a report into equity crowd funding recommending regulatory changes to facilitate and stimulate industry development.<sup>52</sup>

ASIC has recently been working with peer-to-peer (P2P) lenders to develop appropriate regulation. Entrants in the nascent Australian P2P lending market submit that regulation is valuable in ensuring the industry begins with and maintains high standards.<sup>53</sup> Existing regulation is not seen as an inappropriate barrier to entry, but rather as a mechanism for ensuring new entrants are competent. Regulation is perceived as lifting industry standards and enabling operators “to compete based on providing better products and services to customers”.<sup>54</sup> Submissions from P2P lenders voice support for the current regulatory regime, noting its importance for protecting customers and providing industry with guidance. In this way, regulation can help develop a well-managed, innovative industry.

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50 Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry.

51 Australian Securities and Investments Commission (ASIC) 2014, First round submission to the Financial System Inquiry.

52 Corporations and Markets Advisory Committee 2014, *Crowd sourced equity funding – Report*, Australian Government, Canberra.

53 See, for example, RateSetter Australia 2014, First round submission to the Financial System Inquiry.

54 SocietyOne 2014, First round submission to the Financial System Inquiry.

ASIC has also recently adapted its market integrity rules to mitigate emerging risks related to technology-driven developments in financial markets, including high-frequency trading (HFT) and dark pools.<sup>55</sup> In recent years, there has been significant growth in HFT and off-market trading facilities such as dark pools. Flexibility in ASIC's regulatory framework and approach has enabled it to mitigate resulting market integrity or fairness concerns.<sup>56</sup> However, the dynamism of financial markets means ASIC will need to continue monitoring developments closely and adapt as required.

Government can also facilitate innovation through implementing regulation. For example, the EFT Code (now the ePayments Code) played an important role in developing the electronic payments market.<sup>57</sup> The ePayments Code protects consumers using electronic payment methods, such as ATMs, EFTPOS, debit and credit card transactions, including contactless transactions, online payments, internet banking and BPAY. By setting rules on allocating responsibility for losses, the Code boosted consumer confidence in electronic payments, leading to their mainstream adoption.

#### *Forward-looking mechanisms*

Submissions argue for Government to facilitate innovation through a variety of forward-looking mechanisms. Proposals include:

#### **Setting up a strategic body to oversee technology policy and promote innovation in Australia's financial system.**

Various bodies, such as the Council of Financial Regulators (CFR) and the Financial Sector Advisory Council (FSAC), already monitor developments in the financial system. However, while CFR and FSAC consider the efficiency and effectiveness of regulation, they do not have particular mandates to consider innovation. The *International integration* chapter discusses these bodies further.

In the United Kingdom, the Financial Conduct Authority (FCA) has recently announced 'Project Innovate', an initiative to support industry innovation by smaller start-ups through to established firms with new models.<sup>58</sup> The FCA's policy unit is engaging with firms developing innovative approaches not explicitly covered by

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55 Australian Securities and Investments Commission (ASIC) 2013, 13-213MR ASIC makes rules on dark liquidity, high-frequency trading, media release 12 August, Sydney.

56 Australian Securities and Investments Commission (ASIC) 2013, *Report 331: Dark Liquidity and High Frequency Trading*, ASIC, Sydney; and Australian Securities and Investments Commission (ASIC) 2014, *Report 394: Review of recent rule changes affecting dark liquidity*, ASIC, Sydney.

57 Australian Securities and Investments Commission (ASIC) 2011, 11-205MR ASIC releases new ePayments Code, media release 20 September, Sydney.

58 Wheatley, M 2014, *Making innovation work for firms and customers*, address at Bloomberg, London by Chief Executive, Financial Conduct Authority, 19 May, London.

regulation, or for which application of regulation is ambiguous. Its intent is to support innovators in three ways: first, by providing firms with compliance advice on new models and products; second, by proactively seeking out areas of the framework that need adaptation for new technologies or broader trends; and third, by launching an ‘incubator’ to support innovative small financial businesses as they prepare for regulatory authorisation.

**Developing a comprehensive Government strategy, in consultation with industry, to ensure the regulatory framework supports technological innovation, while managing risks.**

Government already has various technology-related policies and strategies on issues such as e-Government and the digital economy,<sup>59</sup> cloud computing<sup>60</sup> and the uptake of mobile technologies.<sup>61</sup> However, it does not have a single overarching technology strategy in place.

As a significant participant in the financial system, Government can influence the uptake of technology through decisions it makes for its own services. For example, adding the Australian Taxation Office (ATO) to the myGov site — a secure single sign-on site that allows users to access a range of Australian Government services — will double its 2 million registered members by mid-2014.<sup>62</sup> This type of uptake would facilitate the shift to digital delivery of services becoming the default position for the broader Australian economy.

Submissions propose a comprehensive strategy driven from a financial services perspective. Stakeholders suggest such a strategy could consider issues including requirements for electronic disclosures, consumer protection, regulatory perimeter, maintaining a flexible principles-based framework, and updating and implementing the National Cyber Security Strategy.

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59 *The Coalition’s Policy for E-Government and the Digital Economy 2013*, September, Canberra, viewed 30 April 2014, <[http://www.malcolmturnbull.com.au/assets/Coalitions\\_Policy\\_for\\_E-Government\\_and\\_the\\_Digital\\_Economy\\_\(2\).pdf](http://www.malcolmturnbull.com.au/assets/Coalitions_Policy_for_E-Government_and_the_Digital_Economy_(2).pdf)>.

60 Department of Broadband, Communications and the Digital Economy (DBCDE) 2013, *The National Cloud Computing Strategy*, DBCDE, Canberra.

61 Australian Government Information Management Office 2013, *Australian Public Service Mobile Roadmap: Adopting mobile technology across government*, Department of Finance and Deregulation, Canberra.

62 National Commission of Audit 2014, *Report of the National Commission of Audit*, Australian Government, Canberra.

## Policy options for consultation

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

- Establish a central mechanism or body for monitoring and advising Government on technology and innovation. Consider, for example, a public-private sector collaborative body or changing the mandate of an existing body to include technology and innovation.
- Establish a whole-of-Government technology strategy to enable innovation.

*The Inquiry seeks further information on the following areas:*

- Are there specific areas in which Government or regulators need to facilitate innovation through regulation or coordinated action? For example, by facilitating the development of central utilities?
- Are there ways to improve how regulators monitor or address emerging technological developments? For example, through adopting new technologies or mechanisms for industry intelligence gathering?

## Managing information

### *Observation*

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

Many firms now collect, hold and use large amounts of customer data, especially payments data. Some of these firms, including some from outside the financial sector, are seeking to use their vast data stores to gain entry into financial services. For example, Facebook is preparing to provide financial services in the form of remittances and electronic money, seeking regulatory approval in Ireland to do so.<sup>63</sup> Google plans

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<sup>63</sup> Davies, S, Robinson, D and Kuchler, H 2014, 'Facebook shifts focus to financial services', *The Australian Financial Review*, 15 April.

to expand its mobile payments and wallet products and is likewise seeking United Kingdom regulatory approval.<sup>64</sup> Almost half (47 per cent) of bankers recently surveyed believe their biggest competitive threat is from non-financial players — supermarket entrants, payments providers and other forms of disintermediation.<sup>65</sup>

Although starting in payments, many of these firms are seeking to broaden their strategies to target the concept of a customer's 'financial health'. Both traditional and non-traditional firms are developing services to assist and influence consumer decisions on what to buy, and where and when to buy it. These services are designed to encompass all types of products, not only those of a financial nature. For example, services may come in the form of discounts and offers triggered by location-based technologies. Alternatively, they may be packaged as general advice on how to 'spend smarter'.

## Privacy

Information about an individual's finances and creditworthiness forms one of the most sensitive categories of personal information.<sup>66</sup> Financial institutions may hold details such as: account balances; repayment histories; spending patterns including products, store names and locations; tax file numbers; and evidence of income levels. Some institutions may additionally hold information on an individual's health or genetics. In future, they may hold increasing amounts of biometric data. Firms are seeking new ways to use this information to predict the behaviour of individual customers for commercial purposes, raising questions around privacy.

### Preliminary assessment

Firms are collecting and storing growing volumes and types of customer data. As they seek to harness the commercial value of the data, it increasingly raises concerns about the way in which personal information is handled and used. However, it may also present opportunities for improving consumer outcomes. The *Data security and cloud technology* section discusses risks related to data security.

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<sup>64</sup> Davies, Robinson and Kuchler, *The Australian Financial Review*.

<sup>65</sup> Robinson, B and Walker, T 2013, *The financial services industry reaches an inflexion point: 6th annual survey of global financial services challenges, investment priorities and trends*, Temenos White Paper in association with Deloitte, viewed 18 March 2014, <<https://www.temenos.com/en/market-insight/white-papers/inflexion-point/>>.

<sup>66</sup> For example, the *Privacy Act 1988* has specific provisions that deal with tax file numbers and credit-related information and the Office of the Australian Information Commissioner has a series of related fact sheets, viewed 3 June 2014, <<http://www.oaic.gov.au/privacy/privacy-resources/privacy-fact-sheets/credit-and-finance/>>.

### *Benefits*

Most financial services firms are using data analytics to pursue personalised products.<sup>67</sup> For consumers, this is leading to new products, enhanced product functionality and better customer service. Many consumers will also have improved access to products and services, although some may experience more difficulties with access as risk-based pricing becomes increasingly individualised. This is discussed further in the *Underinsurance* section of the *Consumer outcomes* chapter.

For firms, information analytics supports more efficient marketing and better cross-selling opportunities by enhancing their ability to predict the behaviour of individuals. Customer issues can be identified earlier, improving customer satisfaction and retention. Firms can offer consumers lower-cost self-serve options and potentially lower fees and prices. Internal processes, such as fraud and risk management, are also improved.

### *Risks, impediments and opportunities*

However, these benefits come with heightened privacy risks. One submission identifies two main privacy-related risks: first, data might be collected and used in ways a customer might not like; and second, the data might reveal information about persons other than the consenting customer, such as their friends, family or clients.<sup>68</sup> Another submission suggests that, given information analytics enables firms to target the most profitable customers, in some areas, such as extending credit, this may not be in the best interests of customers and may lead to financial hardship.<sup>69</sup> Others note that some segments of the community, such as senior Australians, are particularly sensitive to privacy, safety and security issues.<sup>70</sup>

Some submissions, while acknowledging that privacy protections are important, argue that, in some areas, privacy regulations are overly restrictive and impede efficiency. For example, when assessing creditworthiness, providers lack access to some data sources, such as utility payment history and some Government databases.

Stakeholders also note the difficulties firms with transnational operations face in relation to cross-border information flows. For example, regulatory settings can impose requirements for record keeping that restrict data sharing across branches of the same financial institution located in different jurisdictions. In other cases, laws in one jurisdiction can make it difficult to meet regulatory reporting requirements in

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<sup>67</sup> IBM Institute for Business Value 2013, *Analytics: The real-world use of big data in financial services – How innovative banking and financial markets organizations extract value from uncertain data*, IBM Global Business Services, Somers, May.

<sup>68</sup> Industry Super Australia 2014, First round submission to the Financial System Inquiry.

<sup>69</sup> Consumer Action Law Centre 2014, First round submission to the Financial System Inquiry.

<sup>70</sup> National Seniors Australia 2014, First round submission to the Financial System Inquiry.

another. Institutions may be faced with a choice of complying with the requirements of one jurisdiction over another or ceasing the activity altogether.

Some stakeholders suggest considering mechanisms to provide consumers with broader access to their own data to improve decision making.<sup>71</sup> This could be similar to the United Kingdom Government's 'midata' initiative, which seeks to empower consumers by providing them with secure access to their own data.<sup>72</sup> Another stakeholder suggests giving customers greater control through an opt-in system for use of their data. This might, for example, involve requiring prior customer consent to use their data for cross-selling or enabling a customer to instruct one firm to share their personal data with another.<sup>73</sup> Online comparators and their use of consumer data is discussed in the *Consumer outcomes* chapter. Others argue for more Government data sets to be released to improve industry analysis, risk management and public policy development.<sup>74</sup>

### *Australia's privacy framework*

Following a 28-month inquiry by the Australian Law Reform Commission (ALRC) completed in 2008, privacy law reforms came into effect in March 2014.<sup>75</sup> One of the review's primary drivers was "the rapid advance in information, communication, storage, surveillance and other relevant technologies".<sup>76</sup> It specifically considered how personal information is used in credit reporting, direct marketing and cross-border information flows.

The resulting reforms include 13 Australian Privacy Principles covering the collection, use, disclosure and management of personal information by Government agencies and certain private sector organisations. These reforms are substantial and have only recently been implemented. They require time to take effect. Consequently, assessing their effectiveness at this point will be of limited benefit, although a future review may be appropriate.

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71 For example, refer to Choice 2014, First round submission to the Financial System Inquiry.

72 United Kingdom Government 2014, *Providing better information and protection for consumers*, United Kingdom Government, viewed 13 May 2014, <<https://www.gov.uk/government/policies/providing-better-information-and-protection-for-consumers/supporting-pages/personal-data>>.

73 Industry Super Australia 2014, First round submission to the Financial System Inquiry.

74 Actuaries Institute 2014, First round submission to the Financial System Inquiry.

75 Office of the Australian Information Commissioner 2014, *Privacy Fact Sheet 17: Australian Privacy Principles*, Australian Government, Canberra.

76 Australian Law Reform Commission (ALRC) 2008 (modified 2013), *ALRC Report 108 – For Your Information: Australian Privacy Law and Practice*, Australian Government, Canberra, page 19.

## Policy options for consultation

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

*The Inquiry seeks further information on the following areas:*

- What options could be explored for providing consumers with more control over use of their data and/or better access to their own data in useful formats to improve decision making and consumer outcomes?
- What additional Government data sets could be released to improve consumer outcomes, industry analysis and public policy development via data.gov.au, taking into account relevant privacy requirements?

## Data security and cloud technology

### Preliminary assessment

Growth in both the amount of data held and used by firms and in the use of cloud technology potentially increases efficiency, but concurrently intensifies operational risks related to privacy, security and control of data. Risks related to the use of information are discussed in the *Privacy* section.

### *Data security*

The growing amount of data stored and used by firms can bring many benefits to consumers, businesses and Government. However, it also creates the risk of a data breach exposing large amounts of sensitive customer information, especially given the increased sophistication and frequency of cyber attacks. For example, a recent study on global threat activity reported that, worldwide, the number of data breaches had

grown by 22 per cent between 2011 and 2013.<sup>77</sup> Compounding this increase in frequency, the growth in the size of each breach resulted in the number of individuals who had their personal information<sup>78</sup> exposed more than doubling, from 232 million to 552 million over the same period.

Many submissions recognise the importance of institutions safeguarding the customer information they hold. If Australians do not trust institutions to protect their personal information, this will impede the ability to transact and conduct business online. A recent study shows data breaches not only negatively impact Australian businesses, in terms of the direct costs of managing the consequences of the breach; they also significantly damage reputation and drive away customers.<sup>79</sup> The study also found that data breaches are more likely to occur in retail and financial services than other sectors, and these sectors are more susceptible to high customer turnover.

Currently, where data breaches involve personal information, there are no mandatory requirements to report the incident to the Office of the Australian Information Commissioner (OAIC)<sup>80</sup> or notify affected individuals under the *Privacy Act 1988*. In 2012, the ALRC recommended this be amended.<sup>81</sup> Mandatory notifications can help individuals regain control over personal information. Being transparent about handling information can help rebuild public trust by demonstrating that an organisation takes its obligation to protect personal information seriously. Similarly, notifying the OAIC may help reinforce this, and it may also assist the OAIC in handling inquiries and managing complaints.<sup>82</sup>

### *Cloud technology*

Cloud technology has the potential to improve the efficiency of financial service provision. For example, shifting to cloud services has reduced the Commonwealth Bank's storage, app testing and development costs by 50 per cent — above the

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77 Symantec 2014, *Internet Security Threat Report 2014, 2013 Trends*, vol 19, Symantec, Mountain View, viewed 5 June 2014,

<[http://www.symantec.com/security\\_response/publications/threatreport.jsp](http://www.symantec.com/security_response/publications/threatreport.jsp)>.

78 Personal information includes credit card details, birth dates, government identification numbers, home addresses, medical records, phone numbers, financial information, email addresses, log-in details and passwords.

79 Ponemon Institute 2014, *2014 Cost of Data Breach Study: Australia*, benchmark research sponsored by IBM, Ponemon Institute, Traverse City.

80 Under the 2014-15 Budget, the Australian Government announced plans to disband the OAIC by 1 January 2015.

81 Office of the Australian Information Commissioner 2012, *Data Breach Notification: A guide to handling personal information security breaches*, Australian Government, Canberra.

82 Office of the Australian Information Commissioner 2012, *Data Breach Notification: A guide to handling personal information security breaches*, Australian Government, Canberra.

40 per cent savings the bank expects from cloud migration.<sup>83</sup> Previously, 75 per cent of the bank's IT expenditure was on infrastructure. Cloud usage has reduced this to 26 per cent, freeing up capital for innovative developments in business logic and customer-facing technologies.<sup>84</sup> A recently released Government report into cloud computing regulation also recognises the innovation and productivity benefits of the technology.<sup>85</sup>

Consequently, a number of submissions argue for flexibility in cloud technology regulation, particularly in any future guidelines to be developed by the Australian Prudential Regulation Authority (APRA).<sup>86</sup> One submission notes that "because of its scale, cloud computing infrastructure is cheaper to run, more flexible to use, and can provide greater security, with the ability to update services rapidly with enhanced safeguards".<sup>87</sup> Submissions suggest that, to encourage the uptake of these technologies or those of other third-party providers, regulatory guidelines should take a principles-based rather than prescriptive approach.

Although cloud technology offers many benefits, its use also potentially dilutes a firm's control over its data and systems, increasing security risks. In addition, where a cloud provider is located offshore, a regulator may have limited capacity to obtain information, investigate or take enforcement action where necessary. Stakeholders acknowledge the importance of protecting customer data and core infrastructure, and therefore the need for APRA to develop guidelines. One submission also observes that APRA should monitor the concentration risk on a system-wide basis, given the increased reliance of firms on a potentially small number of third-party providers.

From a consumer perspective, use of cloud technology also has the potential to introduce some level of confusion in relation to who is accountable to the consumer. In particular, where cloud solutions are provided by a third party, questions may arise if a consumer's private data is handled inappropriately or financial services transactions are not administered to an appropriate standard.

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83 Duckett, C 2012, 'CBA striving for 'pure cloud' amid vendor garbage', *ZDNet*, 14 November, viewed 3 March 2014, <<http://www.zdnet.com/au/cba-striving-for-pure-cloud-amid-vendor-garbage-7000007357/>>.

84 Foo, F 2012, 'CBA saves millions from cloud services', *The Australian*, 29 November.

85 Department of Communications 2014, *Cloud computing regulatory stock take*, report version 1, Australian Government, Canberra.

86 Note in 2010, APRA issued a letter to industry regarding cloud computing. See Australian Prudential Regulation Authority (APRA) 2010, Letter to ADIs, GIs and LIs, Outsourcing and Offshoring: Specific considerations when using cloud computing services, APRA, Sydney, 15 November.

87 Australian Bankers' Association 2014, First round submission to the Financial System Inquiry.

## Policy options for consultation

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

## Security

### *Observation*

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

## Cyber security

### Preliminary assessment

#### *Cyber security's growing importance*

The rise of e-commerce and widespread internet connectivity expose financial institutions to increasingly more cyber crime. Cyber attacks may cause service outages, failure of core operating systems, increased fraud, theft of intellectual property and loss of sensitive data. Criminal and malicious actors – state and non-state – seek ways to disrupt services, access personal and corporate data, and steal resources. Organised crime uses increasingly sophisticated techniques, particularly in money laundering and identity crime, to facilitate other illegal activities.

Cyber attacks are no longer only a potential threat; they are occurring on an increasingly frequent basis. For example, recent figures show a 21 per cent rise in cyber threats to Australian Government networks between 2012 and 2013.<sup>88</sup> In considering

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<sup>88</sup> Cyber Security Operations Centre 2014, *The Cyber Security Picture 2013*, Australian Government, Canberra.

national security risks, the Government has assessed cyber security risk to the Australian economy as high.<sup>89</sup> Consequently, cyber security is one of the Government's top national security priorities, and the financial system is considered a component of Australia's critical infrastructure.<sup>90</sup> The financial industry is a key target of cyber crime, alongside the resources, defence, telecommunications and technology sectors.<sup>91</sup>

Although managing cyber security risks creates costs for industry and Government, there are also costs from failing to take action. For example, in 2013 cyber crime affected 5 million Australians at an estimated cost of \$1.06 billion.<sup>92</sup> Cyber crime may erode consumer and business trust and confidence in the financial system. Increasingly, cyber crime is also being identified as a potential source of systemic risk.<sup>93</sup>

### *Australia's Cyber Security Strategy*

In Australia, the Department of Prime Minister and Cabinet provides whole-of-Government coordination on cyber security policy under the Cyber Security Strategy (CSS). The CSS, released in 2009, is designed to maintain a "secure, resilient and trusted electronic operating environment that supports Australia's national security and maximises the benefits of the digital economy".<sup>94</sup>

Submissions consistently raise concerns that the CSS needs to be reviewed and updated, and that a strategy from 2009 is out of date in a rapidly changing threat environment. A recent Government report also warns of the need for organisations to be continually vigilant and up to date in network security to deal with the "increasing skill and resourcefulness of cyber adversaries".<sup>95</sup>

Australia's CSS is the least up to date among the national cyber security strategies of the United States (2011), the United Kingdom (2011), Canada (2010), New Zealand

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89 Attorney-General's Department, *Cyber security*, Australian Government, viewed 11 June 2014, <<http://www.ag.gov.au/RightsAndProtections/CyberSecurity/Pages/default.aspx>>.

90 Brangwin, N 2013, 'Cyber security', *Parliamentary Library Briefing Book: Key Issues for the 44th Parliament*, Parliament of Australia, Canberra.

91 Brangwin, N 2013, 'Cyber security', *Parliamentary Library Briefing Book: Key Issues for the 44th Parliament*, Parliament of Australia, Canberra.

92 Symantec 2013, 2013 Norton Report: Total Cost of Cybercrime in Australia amounts to AU\$1.06 billion, media release 16 October, Sydney.

93 See, for example, Tendulkar, R 2013, *Cyber-crime, securities markets and systemic risk*, joint working paper of the International Organization of Securities Commissions Research Department and World Federation of Exchanges Office, Madrid, 16 July.

94 Australian Government 2009, *Cyber Security Strategy*, Australian Government, Canberra, page 4.

95 Cyber Security Operations Centre (CSOC) 2014, *The Cyber Security Picture 2013*, Australian Government, Canberra, page 1.

(2011), France (2011), Germany (2011), Japan (2013) and Singapore (2013).<sup>96</sup> Given the complexity and dynamic nature of the threat, stakeholders emphasise the importance of cyber security being managed strategically at a national level, hence the need for a refreshed strategy.

### *Implementation of cyber security policy*

Due to its broad-ranging implications, many agencies are involved in implementing cyber security policy. The CSS identifies nine main agencies or bodies with significant cyber security responsibilities, such as the Attorney-General's Department (AGD), and various communications, defence and intelligence agencies. The CSS also established two new organisations in 2009: the Computer Emergency Response Team (CERT) Australia and the Cyber Security Operations Centre, both of which will now be co-located within the recently announced Australian Cyber Security Centre (ACSC).<sup>97</sup>

In January 2013, the Government announced the establishment of the ACSC as part of the National Security Strategy.<sup>98</sup> The ACSC is the joint responsibility of the Attorney-General and the Minister for Defence and will be overseen by the Cyber Security Operations Board (CSOB). The CSOB consists of agency heads and secretaries and is responsible for strategic oversight of the Government's operational cyber security capabilities and coordination of cyber security measures.<sup>99</sup>

The ACSC brings together cyber security expertise from the Australian Signals Directorate (ASD), Australian Security Intelligence Organisation, AGD, Australian Federal Police and Australian Crime Commission (ACC).<sup>100</sup> The ACSC will focus on threat identification and assessment, as well as coordinating operational responses to threats of national importance. The ACSC will also aim to improve partnerships between Government agencies and with industry.<sup>101</sup> It is expected to be operational in late 2014.<sup>102</sup>

A range of other agencies also play roles in cyber security; for example, in areas such as anti-money laundering, privacy and international cooperation against cyber threats.

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96 NATO Cooperative Cyber Defence Centre of Excellence 2014, *National strategies and policies*, 10 March, viewed 11 June 2014, <<https://ccdcoe.org/328.html>>.

97 Australian Signals Directorate 2014, Australian Cyber Security Centre, Department of Defence, viewed 23 June 2014, <<http://www.asd.gov.au/infosec/acsc.htm>>.

98 Brangwin, N 2013, 'Cyber security', *Parliamentary Library Briefing Book: Key Issues for the 44th Parliament*, Parliament of Australia, Canberra.

99 Australian Signals Directorate 2014, Australian Cyber Security Centre, Department of Defence, viewed 23 June 2014, <<http://www.asd.gov.au/infosec/acsc.htm>>.

100 Brangwin, N 2013, 'Cyber security', *Parliamentary Library Briefing Book: Key Issues for the 44th Parliament*, Parliament of Australia, Canberra.

101 Department of Defence 2013, *Defence White Paper 2013*, Australian Government, Canberra.

102 Australian Signals Directorate 2014, Australian Cyber Security Centre, Department of Defence, viewed 23 June 2014, <<http://www.asd.gov.au/infosec/acsc.htm>>.

In addition, a number of joint public–private sector committees exist for cyber and fraud threats. For example, the Australian Federal Government and Banking Industry Security Governance Forum for sharing intelligence on cyber threats, and the National Fraud Exchange for fraud intelligence sharing across Australian financial institutions.<sup>103</sup>

Stakeholders suggest there could be more cohesion and coordination in implementing cyber security policy. They note that many of the organisations involved tend to be focused on tactical and operational issues, rather than strategic matters. Consequently, some of the strategic and forward-planning aspects are given less emphasis. For example, if a major cyber attack occurs, the roles and responsibilities for Government and the private sector are unclear. Developing a forum for private and public sector discussion of strategic issues has been suggested as a way of addressing these matters.

### *Information sharing and collaboration*

Although the private sector itself collects significant amounts of threat information, Government is in a unique position to gather intelligence and should have effective mechanisms to share information with industry. Currently, CERT Australia and the ASD play roles in disseminating threat information to industry. Other Government organisations, such as the Trusted Information Sharing Network, also contribute.<sup>104</sup>

However, stakeholders suggest that information flows between the public and private sector could be improved, particularly in relation to real-time actionable intelligence. Stakeholders also suggest improved sharing of intelligence with other sectors, such as the telecommunications sector.

While recognising industry collaboration already occurs, submissions argue that cyber security risk management could be improved by greater collaboration between Government, regulators and industry. Although stakeholders acknowledge that financial institutions retain ultimate responsibility for maintaining the security of their own systems, they note that collaborating with Government can help institutions fine tune their efforts. The CSS itself includes as one of its guiding principles the importance of partnerships and collaboration with the private sector and broader Australian community.

In a recent example of collaboration in the United Kingdom, the Bank of England is working with industry to test and improve the sector’s cyber resilience through its

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103 ANZ 2014, First round submission to the Financial System Inquiry.

104 The Trusted Information Sharing Network enables information sharing between business and government to protect critical infrastructure and essential services in the face of all hazards.

CBEST initiative.<sup>105</sup> CBEST is a framework to deliver targeted cyber security tests, but differs from traditional testing in that it is based on real and current cyber threat intelligence. Tests replicate the sophisticated and persistent attacks of threat actors to assess an institution's capabilities.<sup>106</sup>

Another collaborative model suggested by stakeholders is the Financial Services Information Sharing and Analysis Center (FS-ISAC) based in the United States. The FS-ISAC is a member-funded and -managed, government-endorsed organisation that gathers threat, vulnerability and risk information about cyber and physical security risks faced by the financial services sector globally.<sup>107</sup> Information is sourced from government and law enforcement agencies, private sector institutions, and academic and other trusted sources. The FS-ISAC delivers alerts to member organisations and provides various services based on a tiered system of membership.

Stakeholders note that the global nature of both e-commerce and cyber threats increases the potential need for regional and international cooperation on cyber security issues. Recognising this, although it has always had members with global operations, the FS-ISAC recently extended its charter to specifically include information sharing with financial services firms worldwide.<sup>108</sup>

### *Lifting industry standards*

Stakeholders argue that cyber security issues occur in an ecosystem where the capability of individual institutions affects the capability of the financial system as a whole. In other words, although some stakeholders have strong cyber security capabilities, they are still exposed to 'weak links' in the chain. Larger players generally have more capacity – and as larger targets, more incentive – to invest in cyber security. Smaller players are lesser targets; however, they can potentially be more vulnerable, as they typically lack the scale to invest to the same extent. Vulnerabilities can also arise from outside the sector; for example, during information transfer to technology service providers with inadequate data encryption standards. These differing capabilities heighten the need for Government to take a systems perspective in managing cyber security risks.

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105 Bank of England (BoE), *CBEST Vulnerability Testing Framework Launch*, BoE, London, viewed 11 June 2014, <<http://www.bankofengland.co.uk/financialstability/fsc/Pages/cbest.aspx>>.

106 Bank of England (BoE), *An Introduction to CBEST*, BoE, London, viewed 11 June 2014, <http://www.bankofengland.co.uk/financialstability/fsc/Documents/anintroductiontocbest.pdf>.

107 Financial Services Information Sharing and Analysis Center (FS-ISAC), *FAQs*, FS-ISAC, viewed on 12 June 2014, <<https://www.fsisac.com/faqs>>.

108 Financial Services Information Sharing and Analysis Center (FS-ISAC), *About FS-ISAC*, FS-ISAC, viewed on 12 June 2014, <<https://www.fsisac.com/about>>.

Firms with less capacity to invest in cyber security may require access to more information and advice from Government and industry sources. One submission suggests Government might follow the United States example in issuing guidelines to enhance cyber security across the industry and other critical sectors.<sup>109</sup> In the United States, the Department of Commerce’s National Institute of Standards and Technology (NIST) recently released a *Framework for Improving Critical Infrastructure Cybersecurity*.<sup>110</sup> The framework is the result of public-private sector collaboration and is voluntary and risk-based. It provides a set of industry standards and best practices to assist organisations in managing cyber security risks. It is intended to be scalable to meet different organisations’ needs, without adding regulatory burden.<sup>111</sup>

### Policy options for consultation

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:*

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

*The Inquiry seeks further information on the following areas:*

- Would a private-public sector discussion forum for strategic issues, such as cyber crisis planning, improve cohesion in implementing cyber security policy? What other mechanisms might assist to improve cohesion or coordination?
- Is there a need for more cross-sectoral or transnational mechanisms for information sharing, or for Government to work with industry to initiate the development of a collaborative model similar to the United States FS-ISAC?
- How useful would a voluntary cyber security framework, similar to that of the United States NIST, be in assisting industry to develop cyber capabilities?

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109 Australian Bankers’ Association 2014, First round submission to the Financial System Inquiry.

110 National Institute of Standards and Technology 2014, *Framework for Improving Critical Infrastructure Cybersecurity*, Version 1.0, US Department of Commerce, Gaithersburg , 12 February.

111 National Institute of Standards and Technology 2014, *Framework for Improving Critical Infrastructure Cybersecurity*, Version 1.0, US Department of Commerce, Gaithersburg , 12 February.

## Digital identity

### Preliminary assessment

#### *An essential function*

Participants in Australia's financial system have always needed, and continue to need, confidence in a person's identity. At its simplest, confirming a person's identity helps prevent others from misappropriating that identity to conduct illicit financial transactions or other illegal activities.

Consumers' growing preferences for accessing financial services through online and digital channels is increasing the need for efficient digital identity verification and authentication solutions. Traditionally, identity verification has involved sighting and collecting an individual's original, government-issued identifying documents face to face. In a digital environment, this process is slow and onerous for customers and expensive and cumbersome for organisations.

Submissions note both the importance of trusted digital identities to the financial system and heightened concerns over identity theft. For example, one submission notes that the superannuation industry is becoming increasingly attractive as a target for identity theft, as the size of member account balances grows.<sup>112</sup> Trusted digital identities can stimulate the digital economy by increasing trust and enabling more sensitive transactions to be conducted online. Conversely, lack of consumer trust can result in 'e-friction', impeding the growth of the digital economy.<sup>113</sup> Arguably, as the digital economy grows, systems and processes associated with digital identity management may increasingly be considered a type of critical infrastructure.

#### *Identity crime*

Trusted digital identities are important in helping prevent identity-related crime and fraud. Identity crime costs Australian consumers, businesses and Government. For example, in 2011 Australians lost an estimated \$1.4 billion through personal fraud incidents related to credit card fraud, identity theft and scams.<sup>114</sup> Over five months in 2011, the ATO identified more than 7,300 income tax returns as suspected cases of identity crime; claimed refunds were worth approximately \$36 million.<sup>115</sup> The ACC

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112 Association of Superannuation Funds of Australia 2014, First round submission to the Financial System Inquiry.

113 The Boston Consulting Group (BCG) 2014, *The Connected World: Greasing the Gears of the Internet Economy*, BCG, January.

114 Australian Bureau of Statistics (ABS) 2012, *Personal Fraud, 2010–2011*, cat. no. 4528.0, ABS, Canberra.

115 Australian Crime Commission 2013, *Organised Crime in Australia 2013*, Australian Government, Canberra.

rates identity crime as a key enabler of serious and organised crime, which in turn costs Australia \$15 billion annually.<sup>116</sup>

Identity crime is one of the most common types of crime in Australia. A 2013 survey by the Australian Institute of Criminology found almost 10 per cent of Australians had suffered theft or misuse of their personal information in the previous 12 months.<sup>117</sup> More than half of those who had suffered misuse of personal information had experienced financial losses as a result, with an average loss of approximately \$4,000, ranging to over \$300,000 in the most serious case.

### *Australia's identity infrastructure*

In Australia, there is no single government identity credential; instead, the identity infrastructure is provided by approximately 20 government agencies managing over 50 million core identity credentials.<sup>118</sup> This decentralised model is referred to as a federated identity system, which tends to emphasise market-based solutions. Multiple identity credentials are produced by government and commercial providers to provide access to public and private sector services. Under a syndicated model, a single identity credential is issued – typically by government – providing single sign-on access to public and private sector services.

Financial services firms form an important part of Australia's identity infrastructure. They both use the government-sourced identity infrastructure to perform identity management functions, and they form part of the infrastructure, as they themselves issue documents that are often subsequently used to prove identity, such as debit and credit cards. Financial services firms are also significant innovators in this area.

In Australia, when a person seeks to use financial services, anti-money laundering (AML) legislation requires firms to meet 'know your client' (KYC) identity management and verification obligations.<sup>119</sup> Stakeholders observe that these requirements, combined with a federated identity model, can result in significant process duplication as firms verify and re-verify identities. This is particularly the case where firms are not permitted to rely on the identity verification processes of other trusted firms.

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116 Australian Crime Commission 2013, *Organised Crime in Australia 2013*, Australian Government, Canberra.

117 Smith, R G and Hutchings, A 2014, *Identity crime and misuse in Australia: Results of the 2013 online survey*, Research and Public Policy Series 128, Australian Institute of Criminology, Canberra.

118 Attorney-General's Department 2014, *National Identity Proofing Guidelines*, Draft Version 5.1, Australian Government, Canberra.

119 *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*.

Although Australia has a National Identity Security Strategy, it does not set out a detailed comprehensive approach to the issue of digital identities.<sup>120</sup> However, it has resulted in the development of significant building blocks, such as the Document Verification Service (DVS). This secure online service enables government agencies, financial institutions and other businesses to verify information on identity documents directly with the document issuing agency.<sup>121</sup> In addition to preventing identity crime, the DVS helps to reduce AML and other compliance costs related to customer identity verification. Other initiatives include an assurance framework for accrediting commercial identity service providers,<sup>122</sup> a national (identity) e-authentication framework,<sup>123</sup> and identity proofing guidelines<sup>124</sup> for government agencies and businesses.

The myGov digital service provides a potential basis for a Government-issued digital identity.<sup>125</sup> myGov provides Australians with secure single sign-on access to various government services, including Medicare, Centrelink, electronic health records and tax records, including a digital mailbox to receive government correspondence. The National Commission of Audit has recommended that myGov be a core component of a strategy to shift government services to a default position of delivery by digital channels.<sup>126</sup>

Submissions question the cost and effectiveness of current identity arrangements, including compliance requirements under AML rules. Globally, AML compliance costs increased by an average of 53 per cent in the three years to 2014. This trend is expected to continue, driven by the increasing costs of transaction monitoring systems and meeting KYC requirements.<sup>127</sup>

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120 Attorney-General's Department 2013, *National Identity Security Strategy 2012*, Australian Government, Canberra.

121 Attorney-General's Department (AGD) 2013, *Documentation Verification Service*, AGD, Canberra, viewed 12 June 2014, <<http://www.dvs.gov.au/Pages/default.aspx>>.

122 Australian Government Information Management Office 2013, *Third Party Identity Services Assurance Framework*, Department of Finance, Australian Government, Canberra.

123 Australian Government Information Management Office, *National e-Authentication Framework*, Department of Finance and Deregulation, Australian Government, Canberra, January 2009.

124 Attorney-General's Department 2014, *National Identity Proofing Guidelines*, Draft Version 5.1, Australian Government, Canberra.

125 Australian Government, *myGov*, Australian Government, Canberra, viewed 12 June 2014, <<https://my.gov.au/mygov/content/html/about.html>>.

126 National Commission of Audit 2014, *Report of the National Commission of Audit*, Australian Government, Canberra.

127 KPMG 2014, *Global Anti-Money Laundering Survey*, KPMG, viewed 3 March 2014, <<http://www.kpmg.com/au/en/IssuesAndInsights/ArticlesPublications/Documents/global-anti-money-laundering-survey-regional-commentary.pdf>>.

Stakeholders are seeking ways to develop more efficient and secure identity processes. Existing commonly used processes such as passwords can be problematic. The average Australian maintains between five and 50 different login and password combinations for their online activities. This is challenging for individuals and firms: 20 to 30 per cent of all IT service desk requests relate to password problems. Estimates indicate the cost of password resets alone is approximately US\$1 billion globally.<sup>128</sup> For the Oceania region, enabling e-government services via digital identities could generate US\$1.5 billion in savings annually by 2020.<sup>129</sup>

Stakeholders vary significantly in their views on how identity management can be improved in Australia. Some have suggested developing a Government-sponsored central utility for verifying customer identity. Others seek to develop identity services by leveraging their existing branch networks and services in partnership with Government. Some want access to additional Government information to provide these services themselves, rather than relying on Government.

### *International developments*

Internationally, different jurisdictions are positioned at various points along the spectrum between federated and syndicated identity models. Towards the federated end, examples include the:

- **United States National Strategy for Trusted Identities in Cyberspace** – enables commercial providers to compete to produce credentials in accordance with standards set out under multiple accredited trust frameworks. A Federal Cloud Credential Exchange is being set up by the United States Government within the United States Postal Service to facilitate federal agencies in accepting accredited third-party digital credentials.<sup>130</sup>
- **United Kingdom Identity Assurance Program** – allows accredited commercial identity providers to issue credentials providing access to multiple government services.<sup>131</sup> Its standards-based approach relies on a hub that enables authentication

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128 Research by the Australian Communications and Media Authority, cited by Senator George Brandis QC, Attorney-General and Minister for the Arts 2014, address at the opening plenary of the CeBIT Australia 2014 Conference, 5 February, Sydney.

129 Secure Identity Alliance 2014, *The role of trusted digital identity in enabling the eGovernment 2020 vision*, Secure Identity Alliance, Paris, February, viewed 14 May 2014, <[http://www.securitydocumentworld.com/creo\\_files/upload/article-files/140206\\_-\\_digital\\_identity\\_in\\_2020\\_-\\_sia.pdf](http://www.securitydocumentworld.com/creo_files/upload/article-files/140206_-_digital_identity_in_2020_-_sia.pdf)>.

130 National Institute of Standards and Technology (NIST), *About NSTIC*, NIST, United States Department of Commerce, Gaithersburg, viewed 12 June 2014, <<http://www.nist.gov/nstic/about-nstic.html>>.

131 Cabinet Office 2012, *Identity assurance: delivering trusted transactions*, United Kingdom Government, London, viewed 12 June 2014, <<https://www.gov.uk/government/collections/identity-assurance-enabling-trusted-transactions>>.

without unnecessary transfer, disclosure or storage of data, limiting privacy implications.

- **Canadian Cyber Authentication Renewal Initiative** — provides individuals with a choice of private or public sector identity credentials to access government services.<sup>132</sup> It offers GCKey, a government-provided identity credential, or the option to use SecureKey Concierge, a service that enables individuals to use identity credentials previously issued by partner banks. This model is effectively an authorised brokering service that relies on previous identity verification performed by the banks.

A common theme among these initiatives is the growing role of financial institutions and other private sector organisations in providing identity-related services, traditionally the domain of government.

At the syndicated end, government-developed examples designed specifically to enable digital service delivery include:

- **New Zealand’s RealMe credential** — issued after an in-person interview at a New Zealand Post Office.<sup>133</sup> The applicant must produce their passport, citizenship or birth certificate, or visa, and documents are verified using the Data Validation Service. RealMe allows individuals to consent to and share their personal information with other organisations, such as banks, if they wish.
- **India’s Aadhaar identifier** — India’s new national identification number is linked to fingerprint, iris and facial biometric information captured at registration. The identifier enables access to online and offline government services and is an acceptable form of identity for commercial services such as banking.<sup>134</sup>

Beyond government initiatives, private sector developments include the activities of groups such as the Fast Identity Online (FIDO) Alliance, members of which include MasterCard, Bank of America, Microsoft and Google. The FIDO Alliance is committed to “developing specifications that define an open, scalable and interoperable set of mechanisms that supplant reliance on passwords to securely authenticate users of online services”.<sup>135</sup> Globally, the market for online identity authentication in the

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132 Canadian Radio-television and Telecommunications Commission 2014, *Cyber authentication renewal initiative frequently asked questions for users*, Government of Canada, Ottawa, viewed 12 June 2014, <[http://www.crtc.gc.ca/eng/forms/form\\_405.htm](http://www.crtc.gc.ca/eng/forms/form_405.htm)>.

133 New Zealand Government, *RealMe*, New Zealand Government, Wellington, viewed 12 June 2014, <<https://www.realme.govt.nz/>>.

134 Unique Identification Authority of India (UIDAI), *Aapka Aadhaar*, UIDAI, New Delhi, viewed 12 June 2014, <<http://uidai.gov.in/aapka-aadhaar.html>>.

135 FIDO Alliance 2014, *About the FIDO Alliance*, FIDO Alliance, viewed 2 May 2014, <<https://fidoalliance.org/about>>.

banking sector is forecast to reach US\$1.6 billion by 2018, a 945 per cent increase since 2012.<sup>136</sup>

### *Biometrics*

Using biometric systems for identity verification is becoming increasingly common. Public and private sector organisations are seeking greater levels of assurance in the identities of their customers. Many financial institutions, both in Australia and overseas, have adopted biometrics to improve security around ATMs and phone banking services. For example, one major Australian bank first introduced voice biometrics technology in 2009 and now has more than 150,000 customers with registered voice prints for identity verification when dealing with the bank's call centre.<sup>137</sup> The National Commission of Audit also recently recommended strengthening myGov with biometrics (or face-to-face verification) to enable broader use of the identity credential.<sup>138</sup>

Biometric systems offer considerable potential as a means of preventing identity theft and fraud, improving efficiency and convenience in service delivery, and enabling new online services and business models. However, they come with significant privacy issues and other potential drawbacks. In many cases, biometric information is not secret. For example, people leave fingerprints everywhere. Also, unlike passwords, biometrics cannot be reset after being compromised.

### *Benefits of different models*

A system of trusted digital identities could have significant network benefits throughout the financial sector and the broader digital economy. If financial institutions and other companies could rely on trusted digital credentials, these firms could reduce their own duplicative identity verification processes. This would be more efficient for businesses and more convenient for consumers, who would need to maintain far fewer username and password credentials. Potentially, it could also be more secure, if designed and implemented effectively. Widespread acceptance and mutual recognition of trusted digital identities across the financial sector could also assist customers in transferring accounts between financial institutions.

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136 ABI Research cited in Friedman, O 2013, Online ID and Authentication Market Expected to Grow 945% by 2018 Says ABI Research, But Have Back-End Enterprise Solutions Been Overlooked?, media release, 4 August, Nicosia, viewed 12 May 2014, <<http://www.prweb.com/releases/2013/8/prweb10973967.htm>>.

137 Elsworth, S 2014, 'Biometric banking to become commonplace as banks test voice and facial recognition security', News Corp Australia, 26 May, viewed 3 June 2014, <<http://www.news.com.au/finance/money/biometric-banking-to-become-commonplace-as-banks-test-voice-and-facial-recognition-security/story-e6frfmc1-1226931577826>>.

138 National Commission of Audit 2014, *Report of the National Commission of Audit*, Australian Government, Canberra.

If Government was the default provider of digital identities to Australians, there would be economies of scale and other potential benefits, such as ease of access to Government information sources. This approach is reflected in New Zealand's RealMe service, in which the government conducts high-integrity identity verification, including biometric capture, equivalent to passport application processes, before issuing individuals with their government digital identity.

Equally, Government could help guide and stimulate a commercial market of digital identity products and services. It could work with industry to establish minimum standards in more of a federated 'trust framework' model. In this approach, similar to that of the United Kingdom and United States, consumers could choose between government- and commercially-issued identity credentials. Allowing people to use multiple trusted credentials would have privacy benefits. It would also help reduce the potentially severe consequences where an individual only has a single digital identity, which is then compromised.

Australia's approach to developing trusted digital identities will need to take into account the broader international context. This will help Australian businesses compete in a global identity services market and benefit Australian consumers by facilitating wider acceptance of their digital identities. The Australian and New Zealand Prime Ministers have recently recognised these benefits and agreed to investigate options for mutual recognition of trusted online identities in both countries.<sup>139</sup>

### Policy options for consultation

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:*

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

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<sup>139</sup> Abbott, T (Prime Minister of Australia) and Key, J (Prime Minister of New Zealand) 2014, Joint statement of Prime Minister Abbott and Prime Minister Key, media release 7 February, Sydney.

*The Inquiry seeks further information on the following areas:*

- In developing a national strategy, what should be the respective roles, responsibilities and expectations of Australian public and private sector organisations in creating, accepting and maintaining the digital identities used by Australians?
- Is there a need for Government to enhance identity authentication by facilitating interoperability standards in areas such as biometrics, enabling better access to Government information or improvements to the Documentation Verification Service?



## 10: International integration

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Australia has benefited substantially from financial integration with the rest of the world, most notably from trade and accessing international capital markets over many decades. Benefits have also flowed from opening up Australia's financial services market to foreign competition and from exporting financial services to other markets, although these exports have not been as significant.

Since the global financial crisis (GFC), cross-border capital flows have declined globally, and the international regulatory response to the crisis has in part aimed to reduce the interconnectedness of the global financial system and increase its resilience to shocks. Although the risks are real, there remain long-term benefits from financial integration. The Inquiry supports efforts to drive greater international financial integration, provided they do not compromise appropriate standards for financial stability and conduct in Australia.

This chapter outlines the importance of international integration and provides a basis for engaging with stakeholders in more detail about the existence of impediments and which, if any, need to be addressed. It also discusses Australia's exposure to increasing global regulatory influence and the need for better coordination on integration between Government, regulators and industry.

The Inquiry has made the following observations about the international integration of the Australian financial system:

- Although elements of Australia's financial system are internationally integrated, a number of potential impediments have been identified. Financial system developments in the region will require continuing Government engagement to facilitate integration with Asia.
- Government efforts to promote Australia's policy interests on international standard-setting bodies have been successful. Domestic regulatory processes could be improved to better consider international standards and foreign regulation, including processes for collaboration and consultation for international standard implementation, and mutual recognition and equivalence assessment processes.
- Coordination of Australia's international financial integration could be improved.

## Context

### Financial integration

Financial integration is a country’s financial connectedness with other countries. Greater financial integration tends to increase capital flows and equalise prices and returns on traded financial assets in different countries.<sup>1</sup>

Financial integration and open capital markets offer significant benefits to an economy (see Table 10.1). A number of studies have shown financial integration has positive direct and indirect effects on a country’s economic growth.<sup>2</sup> However, the GFC has reminded us of the risks of contagion from integration with economies experiencing volatility. The international regulatory response to the crisis has, in part, aimed to reduce the interconnectedness of the global financial system and increase its resilience to shocks.<sup>3</sup> Although the risks are real, there remain long-term benefits from financial integration.

**Table 10.1: Benefits and challenges from financial integration<sup>4</sup>**

<b>Benefits of financial integration</b>	<b>Challenges from financial integration</b>
Broadens funding sources and improves access to financial services	Greater exposure to negative external shocks and risks from contagion
Opens up domestic market to competition which can have efficiency gains	Cross-border supervision and enforcement challenges
Greater risk sharing through global diversification and more efficient allocation of global capital	Adverse effects from potential higher volatility in capital flows, effects on asset prices and the financial system’s ability to manage volatility
Foreign direct investment facilitates skill and technology transfers between countries	
Portfolio investment and foreign bank lending can contribute to the deepening of the domestic financial market	

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- 1 De Brouwer, G 2005, ‘Monetary and Financial Integration in Asia: Empirical Evidence and Issues’ *Asian Economic Cooperation and Integration: Progress, Prospects and Challenges*, Asian Development Bank, Manila.
  - 2 Epaulard, A and Pommeret, A 2005, ‘Financial Integration, growth and volatility’, *IMF Working Paper*, WP/05/67, IMF, Washington. and Kose, A, Prasad, E, Rogoff, K and Wei, S 2009, ‘Financial Globalisation: A reappraisal’, *IMF Staff Papers*, vol 56, no.1, IMF, Washington.
  - 3 James, E, McLoughlin, K and Rankin, E 2014, ‘Cross-border Capital Flows since the Global Financial Crisis’, *RBA Bulletin*, June, RBA, Sydney.
  - 4 Based on remarks by Yellen, J 2011, *Reaping the Full Benefits of Financial Openness*, address to Bank of Finland 200th Anniversary Conference, 6 May, Finland.

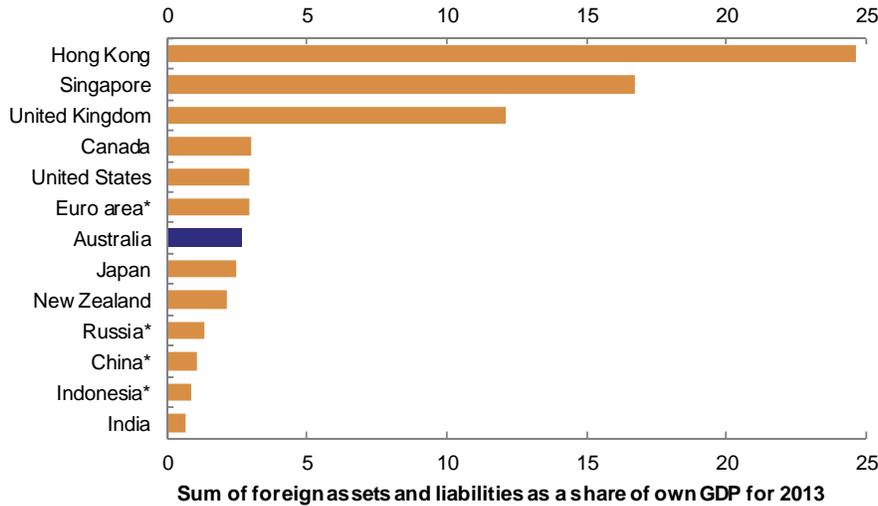
### Assessing Australia’s level of integration

There is no single accepted measure of a country’s level of financial integration. Two common approaches are used:

1. **Quantitative** – assessing levels of international capital and financial flows or price correlation across markets.
2. **Comparative** – surveys or studies comparing features of different economies.

A recent IMF paper considered that preferred quantity-based measures include gross stocks of foreign assets and liabilities as a ratio to GDP.<sup>5</sup> This is shown for some countries in Chart 10.1.

**Chart 10.1: Financial integration across selected comparator countries<sup>6</sup>**



Source: FSI calculations using ABS, IMF, Thomson Reuters, national sources.

Australia is mid-ranking by this measure of financial integration. Unsurprisingly, Australia does not rank as highly as the global financial centres of the United Kingdom, Hong Kong and Singapore. However, Australia ranks close to Canada, a country with a similar economy in terms of size, wealth and governance systems,<sup>7</sup> with

5 Kose, A, Prasad, E, Rogoff, K, Wei, S 2009, ‘Financial Globalisation: A reappraisal’, *IMF Staff Papers*, vol 56, no.1, IMF, Washington.

6 \*Indicates data for 2012.

7 Ciuriak, D 2012, *Canada-Australia commerce: enhancing the relationship*, a report for the Canadian Council of Chief Executives, Australian Industry Group, Sydney, page 1.

Canada also having the advantage of being geographically co-located to the world's largest economy.

Australia has benefited from financial integration with the global financial system. Financial reforms of past decades have delivered the basis for sounder macroeconomic policy, more diversified portfolios for Australian investors and the development of tools for hedging risk.<sup>8</sup> Opening Australia's borders to foreign goods, services and capital played a critical role in productivity growth.<sup>9</sup>

Today, Australian banks and other entities raise foreign funding and invest in foreign assets.<sup>10</sup> Foreigners' willingness to fund Australia's longstanding current account deficit has supported Australia's growth, with international financial flows freeing firms' investment decisions from domestic financing constraints.<sup>11</sup> The Australian dollar is the fifth most traded currency internationally.<sup>12</sup>

Australia's financial sector as a proportion of its economy is large by international standards. It was the largest sector in the Australian economy in 2012–13, representing 8.7 per cent of gross-value added.<sup>13</sup> However, financial services exports only represent a small proportion of Australia's trade, accounting for around 4.5 per cent of total trade in services at the end of 2013.<sup>14</sup>

Australia's main financial relationships are with Europe and the United States. These are the markets where Australia raises capital and makes foreign investments – with around three-quarters of corporate bond issuance conducted offshore, predominantly in the United States.<sup>15</sup> While much of Australia's funding is conducted offshore, Australia also provides a funding source for foreign companies. In March 2014, 36 per cent of total issuance of non-government bonds were 'kangaroo bonds' issued by foreign entities in the Australian domestic market.<sup>16</sup>

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8 Lowe, P 2014, *Some implications of the internationalisation of the Renminbi*, opening remarks to the Centre for International Finance and Regulation Conference on the Internationalisation of the Renminbi, 26 March, Sydney.

9 For further discussion see Banks, G 2005, *Structural reform Australian-style: lessons for others?*, presentation to the IMF, World Bank and OECD, May.

10 See detailed discussion of these flows in the *Funding* chapter.

11 Bank for International Settlements (BIS) 2011, *Annual Report 2010/11*, BIS, Basel, page 33.

12 Reserve Bank of Australia (RBA) 2014, *Developments in Foreign Exchange and OTC Derivatives Markets*, RBA, Sydney, viewed 21 June 2014, <<http://www.rba.gov.au/publications/bulletin/2013/dec/7.html>>.

13 Australian Bureau of Statistics (ABS) 2013, *Australian System of National Accounts*, cat. no. 5204.0, ABS, Canberra.

14 ABS 2014, *International Trade in Goods and Services*, cat. no. 5368.0, ABS, Canberra.

15 Reserve Bank of Australia, 2014, First round submission to the Financial System Inquiry, page 25.

16 Reserve Bank of Australia (RBA), 2014, *Statistical table: Debt Securities Outstanding – D4*, RBA, Sydney, viewed 19 June 2014, <<http://www.rba.gov.au/statistics/tables/index.html>>.

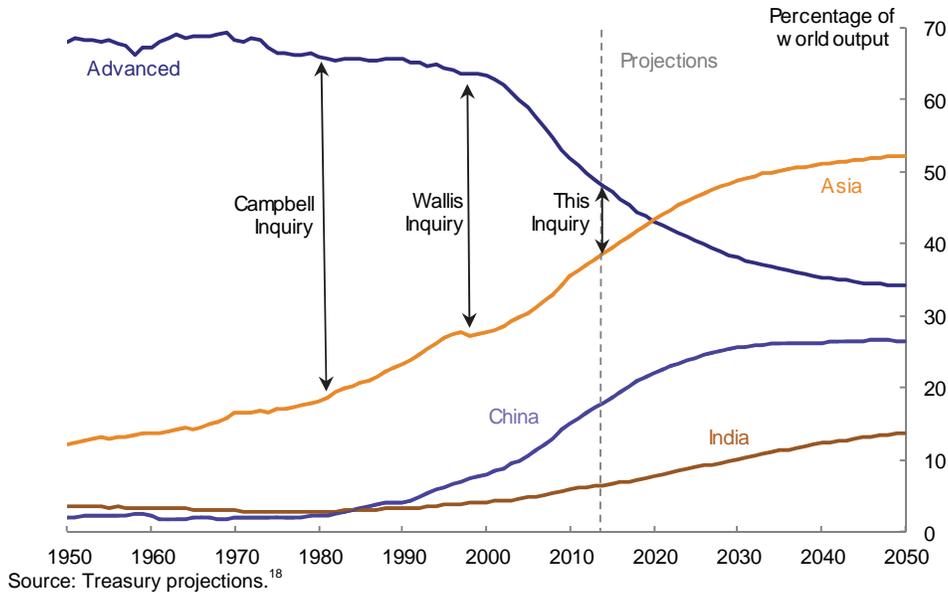
Although Australia has elements evidencing sound financial integration, there are both opportunities and challenges on the horizon. Although the focus of merchandise trade has shifted to the Asian region, financial flows are yet to follow in a substantial way. The pattern of integration is being influenced by cross-border digital connectivity. International rules and regulations will also reshape the level and direction of that integration.

### Integration trends – Growth of Asia

Since the Wallis Inquiry, the weight of the world’s economic activity has been shifting to our region.

Although Europe and the United States are likely to continue to be critical financial markets for Australia, as Asia becomes increasingly middle class and urbanised its share of the global economy is forecast to overtake that of the advanced<sup>17</sup> economies (Chart 10.2).

**Chart 10.2: Past and forecast shift in economic weight**



17 For definition see International Monetary Fund (IMF) 2014, *World Economic and Financial Surveys World Economic Outlook Database – WEO Groups and Aggregates Information*, IMF, Washington, viewed 24 June 2014, <<https://www.imf.org/external/pubs/ft/weo/2014/01/weodata/groups.htm#ae>>.

18 Based on IMF and Conference Board data, as well as Maddison, A 2010, *Statistics on world population, GDP and GDP per capita, 1-2008 AD*, Historical Statistics, Groningen Growth and Development Centre, viewed 21 June 2014, <<http://www.ggdc.net>>. Based on purchasing power parity adjusted GDP.

In the next decade, Asia is forecast to account for more than half of world growth.<sup>19</sup> Asia also has an increasing share of world trade. Presently, four of Australia's top five trading partners are in Asia.

This presents significant opportunities and challenges for the Australian financial system. One of the largest anticipated regional financial system developments will be the liberalisation of China's capital account, and the gradual easing of restrictions on trading in the onshore Chinese currency market by firms from outside of China.<sup>20</sup> At present, China has the largest proportion of world trade, but a currency that is not actively traded.

China has announced a program for relaxing currency and capital controls. In addition to stepped foreign exchange liberalisation, other financial system reforms planned include:

- Ending mandatory low-interest payments on deposits in China
- Allowing deeper competition in banking
- Allowing limited foreign bank entry and a Shanghai free-trade zone for financial services
- Expanding capital control schemes, including the Renminbi Qualified Foreign Institutional Investor (RQFII) scheme, which will allow renminbi (RMB) raised offshore to be invested in listed Mainland bonds and equities, Qualified Foreign Institutional Investor (QFII) and the Shanghai-Hong Kong Stock Connect scheme

As China continues to free up capital controls, a significant proportion of the resultant increase in both portfolio and direct investment flows is likely to be within this region.<sup>21</sup>

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19 Treasury 2013, *Long-term international GDP projections Working Paper 2013-02*, Commonwealth Government, Canberra, viewed 21 June 2014, <<http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Long-term-international-GDP-projections>>.

20 For an overview, see Reserve Bank of Australia (RBA) 2013, 'Developments in Renminbi Internationalisation', *RBA Bulletin*, June Quarter, RBA, Sydney, viewed 21 June 2014, <<http://www.rba.gov.au/publications/bulletin/2013/>>.

21 A number of reports note these developments: see for example ANZ 2014, *Caged Tiger: the transformation of the Asian financial system*, ANZ, Sydney, viewed 21 June 2014, <<http://www.media.anz.com/phoenix.zhtml?c=248677&p=irol-insight>> and Centre for International Finance and Regulation (CIFR) 2014, *Internationalisation of the Renminbi: Pathways, Implications and Opportunities Research Report*, CIFR, Sydney, viewed 21 June 2014, <[http://www.cifr.edu.au/site/Research/Targeted\\_Research\\_RMB\\_Internationalisation.aspx](http://www.cifr.edu.au/site/Research/Targeted_Research_RMB_Internationalisation.aspx)>.

Following China in terms of economic size is India. India's financial system has the potential to provide similar opportunities and challenges for Australia, requiring us to build capacity and develop financial system architecture to connect with India's economic transformation. World Bank modelling suggests that by 2020 China and India together will serve as nearly twice the engine for growth as the United States and the Euro zone combined.<sup>22</sup>

There are also rapid changes underway in Association of Southeast Asian Nations (ASEAN) countries.<sup>23</sup> If ASEAN were a single country, it would be the fifth largest economy in the world, with a combined GDP of \$US3.9 trillion in 2013, in purchasing power parity terms. By 2030, ASEAN is projected to be the equivalent of the fourth largest economy.<sup>24</sup>

### *What does this mean for Australia?*

Currency and capital account liberalisation, and growth in the Asian region generally, are expected to intensify during the decade following this Inquiry. This is likely to have wide-ranging implications for the Australian financial system, some of which are already being observed:

- Potentially significant amounts of Asian direct and portfolio investment moving into markets around the world, including Australia
- Increasing payment of physical trade using RMB
- Deeper capital markets developing in Asia

As capital liberalisation incrementally expands, Asia is likely to become a more important source of funding, especially for portfolio investment. Australian banks and non-financial corporates are increasingly likely to raise funds in RMB and other Asian

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22 The World Bank 2011, *Global Development Horizons 2011: Multipolarity: The New Global Economy*, World Bank, Washington, viewed 21 June 2014, <[http://siteresources.worldbank.org/INTGDH/Resources/GDH\\_CompleteReport2011.pdf](http://siteresources.worldbank.org/INTGDH/Resources/GDH_CompleteReport2011.pdf)>.

23 Association of Southeast Asian Nations (ASEAN) member states: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam. For a description of Australia's trading relationship see Department of Foreign Affairs and Trade (DFAT), *Economic Fact Sheet*, DFAT, Canberra, viewed 21 June 2014, <<http://www.dfat.gov.au/geo/fs/asean.pdf>>.

24 Based on International Monetary Fund (IMF) 2014, *World Economic Outlook*, IMF, Washington, viewed 21 June 2014, <<http://www.imf.org/external/Pubs/ft/weo/2014/01/>> and Treasury 2013, *Working Paper 2013-02, Long-term international GDP projections Working Paper 2013-02*, Treasury, Canberra, viewed 21 June 2014, <<http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Long-term-international-GDP-projections>>.

currencies.<sup>25</sup> Asian financial markets will also become a more important investment destination for Australians.

Some financial centre jurisdictions have a clear timetable for adapting their market and payment infrastructure to deal with changes in the region.<sup>26</sup> The next section discusses the continued Government engagement that will be required to ensure Australian businesses, and all financial system users, can access the opportunities presented by these developments.

### Improving integration

The Inquiry supports efforts to drive greater financial integration, provided it is not at the cost of appropriate standards for financial stability and conduct. The Inquiry sees scope to enhance productivity in the Australian financial services sector through increasing competition, diversity and depth of offering, which would benefit the broader economy and users of Australia's financial system.

This chapter focuses on the following elements:

- Impediments that can be removed or adjusted to accommodate integration, where benefit to the economy as a whole can be demonstrated. This might include removing tax, regulatory or other impediments.
- Identifying where continuing Government involvement and engagement is necessary to facilitate integration with Asia.
- Enhancing domestic regulatory processes to have better regard to international regulatory activity.
- Better coordinating industry, regulators and whole-of-Government. This is seen by most stakeholders as an important element in realising the benefits and managing risks presented by a globally integrated financial system.

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25 For example, in April 2014, Hancock Prospecting Pty Ltd issued CNH 2 billion bonds, through lead managers Bank of China (Sydney Branch), ANZ, CBA, NAB, Royal Bank of Scotland (RBS) and Westpac.

26 See for example City of London Corporation 2014, *London as a centre for renminbi business*, City of London Corporation, London, viewed 21 June 2014, <<http://www.cityoflondon.gov.uk/business/support-promotion-and-advice/promoting-the-city-internationally/china/Pages/London-as-a-centre-for-international-renminbi-business.aspx>>.

## Impediments to financial integration

### Preliminary assessment

#### *Observation*

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

### Impediments to financial integration

This Inquiry has the benefit of following a number of Government inquiries and private sector reviews that have put forward proposals to promote integration. The most recent Australian Government report in 2012, *Australia in the Asian Century White Paper*,<sup>27</sup> recommended that Australia develops the skills needed to ensure businesses can take advantage of changes in our region.

The 2009 Johnson report<sup>28</sup> examined opportunities to increase both foreign participation in Australian markets and financial services exports, especially to the growing Asian region. The report concluded the main opportunities for Australian businesses were:

- Australian fund managers managing more offshore-sourced funds
- Banks doing more transactional banking business in the region
- Financial institutions managing offshore business from Australia, rather than overseas

Also, globally published indices are regularly released comparing various national attributes, including 'competitiveness'. Australia is generally ranked highly for liveability, strong rule of law, financial market sophistication, lack of corruption and

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27 Commonwealth Government 2012, *Australia in the Asian Century White Paper*, Commonwealth Government, Canberra, viewed 21 June 2014, <<http://pandora.nla.gov.au/pan/133850/20130914-0122/asiancentury.dpmc.gov.au/white-paper.html>>.

28 Australian Financial Centre Forum 2009, *Australia as a Financial Centre: Building on our strengths*, Commonwealth Government, Canberra, viewed on 21 June 2014, <[http://afcf.treasury.gov.au/afcf/content/final\\_report.asp](http://afcf.treasury.gov.au/afcf/content/final_report.asp)>.

overall economic environment.<sup>29</sup> However, Australia is typically ranked lower on the overall burden of regulation and business focus of regulators.<sup>30</sup>

The elements in these reports and other studies provide useful indicators of the critical factors for successful financial system integration:

- Deep and globally integrated financial markets.
- Strong business environment and well-developed infrastructure.
- Regulators with a global perspective and an understanding of global businesses.<sup>31</sup>

Some submissions note impediments in the business environment that hamper those factors, or where more Government engagement may be required to achieve them.

## Taxation

Submissions suggest that some tax settings in Australia distort international financial flows. Many of these issues have been raised before as part of the Johnson, Australia's Future Tax System and Board of Tax reviews. Table 10.2 below outlines some tax issues, the recommendations from prior reviews and their current status, as understood by the Inquiry.

To the extent that the changes are not being currently progressed, the Inquiry will refer these items to be considered by Australia's Tax White Paper.

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29 Including: PriceWaterhouse Coopers (PWC) 2014, *Cities of Opportunity 6*, PWC, Sydney, viewed 21 June 2014, <<http://www.pwc.com/us/en/cities-of-opportunity/2014/assets/cities-of-opportunity-2014.pdf>> and Economist Intelligence Unit (EIU), *Best cities ranking and report*, The Economist, London, viewed 21 June 2014, <[http://pages.eiu.com/rs/eiu2/images/EIU\\_BestCities.pdf](http://pages.eiu.com/rs/eiu2/images/EIU_BestCities.pdf)>.

30 For example World Economic Forum (WEF) 2013, 'Australia ranked 128th for burden of regulation', *Global Competitiveness Report 12-13*, viewed 21 June 2014, <<http://www.weforum.org/issues/global-competitiveness>>.

31 City of London Corporation 2013, *Local to global: Building a modern financial centre Special Interest Paper*, City of London Corporation, London viewed 21 June 2014, <<http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Pages/From-local-to-global-building-a-modern-financial-centre.aspx>>, and Menon, R 2014, *Singapore's Financial Centre in the New Landscape*, Investment Management Association of Singapore 14th Annual Conference, Singapore, viewed 21 June 2014, <<http://www.bis.org/review/r130313c.pdf>>.

**Table 10.2: Financial integration tax issues raised in submissions**

<b>Tax issue</b>	<b>Explanation</b>	<b>Past review recommendations</b>	<b>Status</b>
Interest withholding tax (IWT)	Submissions argue IWT distorts the funding decisions of financial institutions and places Australia at a competitive disadvantage internationally.	Johnson reco. 3.4: remove IWT. AFTS reco. 33: financial institutions operating in Australia should generally not be subject to IWT on interest paid to non-residents.	Government announced in 2013–14 Mid-year Economic and Fiscal Outlook (MYEFO) not proceeding with IWT removal. <sup>32</sup>
London interbank offered rate (LIBOR) cap for IWT	Caps deductibility in respect of interest paid by an Australian branch to a foreign head office to the applicable LIBOR. Submissions argue LIBOR does not reflect the true cost of raising funds.	Johnson reco. 3.5: remove the LIBOR cap on deductibility of interest paid on branch-parent funding. Considered by the Board of Tax as part of its review of tax arrangements applying to permanent establishments.	The Board of Tax report is yet to be released.
IWT for counterparties (CCPs)	Submissions argue that Australia is at a competitive disadvantage globally as one of the only countries that applies IWT for CCPs.		Treasury released a discussion paper outlining the issues involved in mandatory central clearing in late February 2014. This paper mentioned IWT issues.
Package of reforms aimed at facilitating managed funds	Submissions note the limitations of the current regime and support extending tax flow through treatment to collective investment vehicles (CIVs) other than managed investment trusts (MITs).	Johnson reco. 3.3: recommended the Treasurer request the Board of Tax to review the scope for providing a broader range of tax flow through CIVs. Board of Tax completed a review into CIVs in December 2011.	The Board of Tax report is yet to be released
	Introduce an Investment Manager Regime (IMR) to provide clear and certain tax treatment for transactions undertaken by foreign residents using Australian intermediaries	Johnson reco. 3.1: Introduce an IMR.	Elements 1 and 2 of the IMR have been legislated. Consultation with industry stakeholders is continuing on Element 3.
	New tax system for MITs	Board of Tax review of the tax arrangements applying to MITs.	Government announced start date of 1 July 2015. Some elements of the new tax system have been legislated since the release of the Board's report.

32 Commonwealth Government 2014, *Appendix A: Policy decisions taken since the 2013–14 Budget*, Commonwealth of Australia, Canberra, viewed 21 June 2014, <[http://www.budget.gov.au/2013-14/content/myefo/html/11\\_appendix\\_a\\_revenue.htm](http://www.budget.gov.au/2013-14/content/myefo/html/11_appendix_a_revenue.htm)>.

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Tax issue	Explanation	Past review recommendations	Status
Offshore Banking Unit (OBU)	Submissions seek Government support for OBU regime and clarification of rules.	Johnson reco. 3.2: Remove tax uncertainty about what constitutes an offshore transaction and move some provisions from legislation to regulation.	Government announced start date of 1 July 2015
Islamic financing	Clarify tax treatment of Islamic financing.	Johnson reco. 3.6: recommended Board of Tax review. Board of Tax review completed in 2011.	The Board of Tax report is yet to be released

### Other impediments

Submissions identify other impediments to integration in the following areas:

- Ownership restrictions, particularly in relation to banking and financial market infrastructure.
- Costs and requirements associated with licensing and ongoing compliance costs being barriers to foreign entrants.
- Aspects of prudential settings in Australia having a negative impact on international competitiveness.
- Aspects of prudential setting in Australia and its inconsistency with supporting international expansion, such as the way equity investments in offshore financial services businesses are treated for capital purposes.
- Firms with transnational operations having difficulties in relation to cross-border information flows. For example, regulatory settings can impose requirements for record keeping that restrict data sharing across branches of the same financial institution located in different jurisdictions, acting as an impediment to cross-border activity.
- Australia's trust law needing greater codification to promote better understanding globally of our regulatory structure in a number of private wealth, debt and equity products.
- Lack of access to some international concessional treatments and quotas for investment that would be useful to Australian financial services businesses, such as access to China's RQFII program.
- Anomalies between governance requirements in Australia and some offshore jurisdictions that may place our companies at a competitive disadvantage.

Addressing many of these issues involves trade-offs with other policy objectives.

Although economic theory suggests that international capital flows can boost growth, be a source of resilience for individual economies and provide financial stability benefits, they also make financial conditions more correlated across jurisdictions and create channels for contagion.<sup>33</sup>

The Inquiry supports efforts to drive greater financial integration with the rest of the world, provided it is not at the cost of appropriate standards for financial stability and conduct in Australia. The Inquiry supports removing market and other impediments; enhancing mutual recognition and equivalence processes; and continuing efforts to support Australian regulators to participate in international standard-setting bodies, with a view to advancing Australia's national interest.

The Inquiry does not support tax subsidies or concessions, or market intervention to enhance financial integration.

In considering any recommendations for removing particular impediments in the final report, the Inquiry seeks more detail from stakeholders, particularly on the relative importance of these potential impediments and how changes balance with other policy objectives. Other issues relating to cross-border transactions are discussed in the *Technology* chapter.

### Government engagement – Asia

Although the Inquiry's approach is focused on reducing impediments, proactive Government action will also be required. The region's financial system is already highly regulated and foreign governments are initiating significant changes. Government-to-government dialogue will be needed and industry integration efforts will continue to require Government support.

Although the following discussion focuses on the changes forecast in China, it illustrates the intensity of Government involvement required to ensure access, a smooth transition and risk mitigation for Australia to play an increasing role in the region.

Asia's largest anticipated financial system development will be the liberalisation of China's capital account, and the gradual easing of restrictions on trading in the onshore Chinese currency market by firms from outside China.<sup>34</sup>

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33 Reserve Bank of Australia (RBA) 2014, 'Cross-border Capital Flows since the Global Financial Crisis', *RBA Bulletin*, June Quarter, RBA, Sydney, viewed 21 June 2014, <<http://www.rba.gov.au/publications/bulletin/2014/>>.

34 Reserve Bank of Australia (RBA) 2013, 'Developments in Renminbi Internationalisation', *RBA Bulletin*, June Quarter, RBA, Sydney, viewed 21 June 2014, <<http://www.rba.gov.au/publications/bulletin/2013/>>.

China has set a program for further relaxing currency and capital controls. HSBC forecasts that a third of China's total trade will be settled in RMB by 2015, making RMB one of the top three trade settlement currencies by volume.<sup>35</sup> As China continues to free up capital controls, a significant proportion of the resultant increase in both portfolio and direct investment flows is likely to be in Asia.<sup>36</sup> To date, the level of Government involvement has been significant to ensure that, if commercial and market factors support increased industry activity with China, the Australian financial system's capacity and infrastructure is capable of supporting that interaction.

### *Coordination and raising awareness*

Government capacity building includes efforts to raise awareness of these forecast changes. One of various initiatives is the Australia-Hong Kong RMB Trade and Investment Dialogue — a private sector-led forum facilitated by the Australian Treasury, Reserve Bank of Australia (RBA) and Hong Kong Monetary Authority. The dialogue gives Australian and Hong Kong banks and corporates a forum to discuss the benefits and challenges associated with RMB trade and investment.

Discussions held in Sydney in 2013 and Hong Kong in 2014 were informed by the results of two surveys of corporate attitudes towards RMB trade settlement and investment, conducted by the RBA in 2013 and expanded on by the Centre for International Finance and Regulation in 2014.<sup>37</sup>

Following the 2014 Dialogue, the Group announced its objectives as being to:

- Educate Australian corporates on the risks and rewards arising from RMB trade and capital flows
- Support initiatives to understand better the products and services needed to grow the RMB market in Australia
- Encourage deeper levels of engagement and links between the financial markets in Australia and Hong Kong to better serve the wider Asian market, especially through developing critical infrastructure to support settlement, clearing, liquidity and pricing of RMB

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35 HSBC 2014, *Internationalising the RMB*, HSBC, London, viewed 21 June 2014, <<https://globalconnections.hsbc.com/canada/en/articles/internationalising-rmb>>.

36 Centre for International Finance and Regulation (CIFR) 2014, *Internationalisation of the Renminbi: Pathways, Implications and Opportunities Research Report*, March, CIFR, Sydney, viewed 21 June 2014, <[http://www.cifr.edu.au/site/Research/Targeted\\_Research\\_RMB\\_Internationalisation.aspx](http://www.cifr.edu.au/site/Research/Targeted_Research_RMB_Internationalisation.aspx)>.

37 A summary of the Reserve Bank of Australia (RBA) survey is available in RBA 2013, *Developments in Renminbi Internationalisation*, *RBA Bulletin*, June Quarter, RBA, Sydney, viewed 21 June 2014, <<http://www.rba.gov.au/publications/bulletin/2013/>>.

- Actively collaborate with the Australian and Hong Kong funds and asset management sectors in these efforts<sup>38</sup>

#### Facilitating financial system architecture

In addition to ongoing engagement with the private sector, the Government and regulators have also taken – or are in the process of taking – a number of steps to facilitate the development of the RMB market in Australia. These include:

- Establishing a bilateral local currency swap agreement between the People’s Bank of China and the RBA in March 2012. The agreement is designed to provide market participants with greater confidence regarding the availability of RMB liquidity in Australia, particularly during times of stressed market conditions.
- Introducing direct trading between the Australian dollar and the Chinese RMB – that is, trading between these two currencies without using an intermediate third currency – in the onshore foreign exchange market in April 2013. In time, this is expected to facilitate greater local currency trade invoicing between Australia and China.
- The RBA investing around 3 per cent of its foreign currency reserves in the Chinese sovereign bond market.
- The RBA and People’s Bank of China developing future RMB clearing and settlement arrangements in Sydney.<sup>39</sup> An ‘official’ RMB clearing bank in Australia would be given direct access to the Mainland Chinese foreign exchange and RMB interbank markets to facilitate cross-border trade transactions.

Given the anticipated development in Asian financial markets in coming decades, and the strength and significance of Australia’s trade relationships with the region, opportunities will increasingly arise to access capital from Asia, for Australian and Asian financial services firms to expand into each other’s markets, and to grow financial services exports and imports.

While the Inquiry recognises that much of the success in enhancing financial integration will depend on commercial and market factors, Asian markets are undergoing significant structural changes, which are being shaped to a large degree

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38 Australian Bankers’ Association (ABA) 2014, Second Australia-Hong Kong RMB Trade and Investment Dialogue, media release 22 May, viewed 21 June 2014, <<http://www.bankers.asn.au/Media/Media-Releases/Media-Release-2014/Second-Australia-Hong-Kong-RMB-Trade-and-Investment-Dialogue>>.

39 Hockey, J 2014, Deepening financial ties with China, Canberra, media release, 11 April, Canberra, viewed 21 June 2014 <<http://jbh.ministers.treasury.gov.au/media-release/014-2014/>>.

by governments. Capital and foreign exchange liberalisation are government-initiated activities. Unlike some other regulatory changes, government-to-government dialogue is critical to ensure Australia has prompt access to competency building initiatives and develops appropriate financial system architecture.

*The Inquiry seeks further information on the following areas:*

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

## Cross-border regulatory settings

### Preliminary assessment

*Observation*

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

Regulatory settings are one of the most significant factors affecting the level and nature of international financial integration. Regulatory barriers create friction in financial flows across borders.

Since the GFC, the scope and complexity of cross-border regulation has increased significantly. The Australian financial system is increasingly affected by international standards and foreign regulation. This trend is expected to continue.

There are two sources of this increasing international influence:

1. **Standard setting** by international setting bodies implemented domestically by Australian regulatory agencies:<sup>40</sup> ‘international soft law’.<sup>41</sup> In some cases, this is implemented after international inter-governmental agreements<sup>42</sup> or may be initiated by international standard-setting bodies to promote global convergence of good practice. Implementing an international standard can result in domestic legislation, standards or guidance.
2. **Extraterritorial effect** of other countries’ legislation within Australia.<sup>43</sup> The main issues for the Australian financial system are the cost this imposes where foreign requirements are inconsistent with Australian requirements, and practical compliance implications for Australian financial services providers.

The issues discussed in this chapter mirror the dialogue occurring at an international level to improve processes for forming international standards and assessing conflicts caused by inconsistent foreign regulation.<sup>44</sup> This chapter notes, but does not discuss further, these global issues, instead it focuses on improvements in the domestic context.

Additional issues about Australia’s regulatory environment are also discussed in the *Regulatory architecture* chapter.

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40 For example, Basel Committee on Banking Supervision (BCBS) 2014, *Core Principles for Effective Banking Supervision*, BCBS, Switzerland, viewed 21 June 2014, <<http://www.bis.org/publ/bcbs230.htm>> and International Organization of Securities Commissions (IOSCO) 2010, *Objectives and Principles of Securities Regulation*, Madrid, viewed 21 June 2014, <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>>.

41 Alexander, K, Dhumale, R and Eatwell, J 2006, *Global Governance of Financial Systems*, Oxford University Press, Oxford, pages 134–154.

42 See G20 2009, *Leaders Statement*, Pittsburgh Summit, 24–25 September, Pittsburgh, viewed 24 June 2014, <[https://www.g20.org/sites/default/files/g20\\_resources/library/Pittsburgh\\_Declaration.pdf](https://www.g20.org/sites/default/files/g20_resources/library/Pittsburgh_Declaration.pdf)>.

43 For example, Dodd-Frank Wall Street Reform and Consumer Protection Act, 2000.

44 For example:

- Formed in May 2014, the Cross-Border Regulation Forum (CBRF) is an international group of financial services trade associations, investment banks, brokerage houses, market infrastructure operators and consumers of financial services formed “to help improve and encourage the dialogue on international regulatory standards”. See <[http://www.icsa.bz/img/letter\\_pdf/Annex\\_13.CBRF\\_Response\\_to\\_IOSCOQuestionnaire\\_final\\_ver\\_13.1\\_28\\_MAY\\_2014.pdf](http://www.icsa.bz/img/letter_pdf/Annex_13.CBRF_Response_to_IOSCOQuestionnaire_final_ver_13.1_28_MAY_2014.pdf)>.
- The ‘Financing Growth’ taskforce of the B20 is examining how core global reforms in financial services can be implemented in a way that promotes an integrated global financial system. B20 2014, *Summary of B20 2014 Priorities*, B20, Sydney, viewed 24 June 2014, <<http://www.b20australia.info/priorities-1>>.

## Standard setting

Australia is well placed to be influential in the global context. As the RBA Governor recently noted, “something that is a bit new and, overall, refreshing is that Australia actually does have a place at more of the relevant tables than it used to”.<sup>45</sup> Australia is represented at many levels, and holds leadership positions in some global standard-setting bodies (Table 10.3).

**Table 10.3: Australian representation in selected international groups**

<b>Body</b>	<b>Agency</b>
<b>Group of Twenty (G20)</b>	
President	Australian Government (2014)
Finance Ministers and Central Bank Governors	Reserve Bank, Treasury
Other groups	CFR representatives
<b>Financial Stability Board (FSB)</b>	
Plenary	Reserve Bank, Treasury, (ASIC)
Steering Committee	Reserve Bank, Treasury, (ASIC)
Standing Committee on Assessment of Vulnerabilities	Reserve Bank
Regional Consultative Group for Asia	Reserve Bank, Treasury,
Official Sector Steering Group (on financial benchmarks)	Reserve Bank, ASIC
Other groups	CFR representatives
<b>Bank for International Settlements (BIS)</b>	
Governors Meeting	Reserve Bank
Asian Consultative Council	Reserve Bank
Basel Committee on Banking Supervision (BCBS)	Reserve Bank, APRA
Group of Governors and Heads of Supervision	Reserve Bank, APRA
Committee on Payment and Settlement Systems	Reserve Bank
Other Groups	CFR representatives
<b>International Association of Insurance Supervisors (IAIS)</b>	
Executive Committee	APRA
Technical Committee	APRA
Financial Stability Committee	APRA
Working groups	APRA
<b>International Organization of Securities Commissions (IOSCO)</b>	
Board Chair	ASIC
Asia-Pacific Regional Committee	ASIC
CPSS-IOSCO Steering Committee on Financial Markets Infrastructure (Co-Chair)	ASIC

<sup>45</sup> Stevens, G 2013, *Financial Regulation: Australia in the Global Landscape*, RBA, Sydney, viewed 21 June 2014, <<http://www.rba.gov.au/speeches/2013/sp-gov-260313.html>>.

<b>Body</b>	<b>Agency</b>
Assessment Committee (Chair), Capacity Building Resource Committee (Chair), IOSCO 2020 Task Force (Chair) and Cross Sectoral Taskforce on Securitisation (Co-Chair)	ASIC
Task Force on Unregulated Financial Markets and Products	ASIC
Task Force on Financial Market Benchmarks	ASIC
Other groups	ASIC
<b>International Organisation of Pension Supervisors</b>	
Executive Committee	APRA
Other groups	APRA
<b>Other International Committees</b>	
Asian region based Committees including EMEAP	APRA
OECD Committees	APRA
<b>Financial Action Task Force (FATF)</b>	
President	AGD (2014–15)
Plenary and working groups	AUSTRAC, AGD, DFAT
<b>Egmont Group of Financial Intelligence Units (Egmont)</b>	
Oceania representative	AUSTRAC
Plenary and working groups	AUSTRAC
<b>Asia Pacific Group on Money Laundering (APG)</b>	
Co-Chair (permanent)	AFP
Plenary and working groups	AUSTRAC, AFP, AGD

Source: Provided by Treasury, ASIC, AUSTRAC and APRA.

Submissions support Government efforts to maintain focused international representation. They cite examples of when this representation has assisted outcomes in international standard setting, where those standards apply in the Australian context.

However, submissions also ask the Inquiry to consider changing Australia’s regulatory process to better accommodate the scale and complexity of increasing international influence on the domestic regulatory environment.

Where possible, the domestic application of international standards should be accompanied by transparency and consultation mechanisms. International standards are not always implemented with disclosure and transparency consistent to those that must be applied for domestic regulatory initiatives. For example, consultation processes required by a global standard setter might be truncated, or be inconsistent with priorities for domestic consultation on other local legislation applied to the sector affected.

Submissions request the Inquiry considers mechanisms to ensure:

- Australian representatives on international standard setters have regard to whole-of-Government objectives when participating in international forums. This might simply mean Treasury better coordinating contributions from its agencies and ensuring policy outcomes are consistent across agencies in global forums. Some

submissions suggest a revised Statement of Expectation<sup>46</sup> might clarify that the regulator needs to have regard to broader interests when negotiating at international level.

- Domestic stakeholders have sufficient transparency of international standard-setting agendas and, to the extent possible, are consulted before these standards are applied domestically.
- Other good regulation principles required for Australian regulation are observed, to the extent possible, for standard-setting activities and, in particular, cost/benefit processes are followed to balance regulatory burden with regulatory benefit in the local context.

Examples of these concerns in the prudential standard-setting context are discussed in more detail in the *Stability* chapter. A discussion of Australia's regulation policy develop processes is included in the *Regulatory architecture* chapter.

### Extraterritorial effect of foreign legislation

An increasing volume of foreign regulation is imposed by other countries on Australian business, particularly in financial services. The Australian Bankers' Association (ABA) submission cites examples of legislation emanating from the United States,<sup>47</sup> but notes that most global financial centres apply similar legislation with some extraterritorial effect that can impact financial services businesses in Australia.

There is limited scope for our regulators to influence the implementation of foreign regulation that affects Australia. In this regard, the mutual recognition and equivalence process is an important regulatory tool to support increased financial integration. It minimises regulatory barriers to cross-border activity, while not compromising regulatory standards for financial stability and conduct in Australia.

Foreign regulation is a regulatory reality for the increasing number of Australian businesses that interact with international markets from Australia, or provide services internationally from Australia:

- Large Australian-owned **banks** have increased their activity in Asia over recent years. Exposure of all Australian-owned banks to the Asian region, measured as

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46 Australian Government 2014, *Statements of expectations*, Australian Government, Canberra, viewed 21 June 2014, <<http://www.treasury.gov.au/Policy-Topics/PublicPolicyAndGovt/Statements-of-Expectations>>.

47 Key examples, all from the US, include the Patriot Act, Sarbanes-Oxley Act, Foreign Account Tax Compliance Act and Dodd-Frank. The Australian Bankers' Association (ABA) discusses the impact of some of these pieces of US regulation on the Australian financial system in ABA 2014, First round submission to the Financial System Inquiry, pages 106-108.

aggregate claims, was \$142 billion at September 2013, which has risen from \$22 billion in 2003.<sup>48</sup>

- **Insurers** are also active overseas and expanding into Asia. QBE is a global insurer with 73 per cent of its \$18 billion of premium income sourced outside Australia and New Zealand.<sup>49</sup> IAG, which has \$9.4 billion in gross written premium, noted that 7 per cent of its growth came from Asia in 2012–13.<sup>50</sup>
- A number of **funds managers** have significant global reach; for example, Macquarie had \$US38 billion in assets under management across seven markets in Asia in March 2014.<sup>51</sup>

Around 40 per cent of Australian exporters are small businesses who require financial services to support their activities.<sup>52</sup> Simplifying cross-border regulation is of benefit to these groups as well as larger exporters.

Divergent international and domestic legislative requirements applying to the same business process increase compliance costs, create legal risk and limit the cost efficiencies of scale businesses. Submissions pointing to this development request heightened awareness of the foreign regulation environment in domestic regulatory processes.

The submissions seek to ensure:

- Domestic regulatory processes have regard to the volume and cost of the international regulatory environment when assessing the cost and benefits of domestic regulation.
- Regulatory drafting of financial system requirements has regard to requirements in key regional centres to achieve harmonised legislation, where appropriate.

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48 Reserve Bank Australia 2014, data provided to Financial System Inquiry, 21 March 2014.

49 Calculations based on reported gross written premium, QBE Insurance Group 2013, *2013 Annual Results Presentation*, viewed 21 June 2014, <<http://www.group.qbe.com/investor-centre/reports-presentations>>.

50 IAG 2014, *Financial Results Half Year Ended 31 December 2013*, presentation, IAG, Sydney, viewed 21 June 2014, <[http://www.iag.com.au/results/reports/2014/HY/media/IAG\\_1H14\\_Investor\\_Presentation.pdf](http://www.iag.com.au/results/reports/2014/HY/media/IAG_1H14_Investor_Presentation.pdf)>.

51 Macquarie 2014, *Macquarie in Asia*, Macquarie, viewed 21 June 2014, <<http://static.macquarie.com/dafiles/Internet/mgl/au/about-macquarie-group/investor-relations/events-and-presentations/documents/2014/operational-briefing/alex-harvey-presentation.pdf?v=5>>.

52 Australian Bureau of Statistics (ABS) 2014, *International Trade in Goods and Services, Australia, May 2014*, cat. no. 5368.0.55.006, ABS, Canberra.

- Regulatory agencies have appropriate powers to enter mutual recognition or substituted compliance arrangements to minimise the impact of cross-border regulatory frictions. These arrangements are discussed in more detail below.

### Regulatory recognition arrangements

A challenge for financial services providers operating across borders is meeting the additional national regulatory requirements for each country where services are provided, or that apply in Australia from another country. Given the increasing internationalisation of business, governments around the world are increasingly taking steps to avoid unnecessary duplication, burden and conflict of regulation across borders.

Cross-border regulated activity can be facilitated by:

- **Substituted compliance** – unilaterally recognising another country's regulation
- **Mutual recognition** – recognising each other's regulation as equivalent
- **Multilateral recognition** – recognising a number of countries' regulations as equivalent and allowing 'home' country regulation to meet 'host' country requirements

These arrangements are often facilitated by governments and reduce the regulatory burden for providers seeking to access foreign markets. They have the potential to facilitate quicker market entry, reduce regulatory costs, increase competition and capital flows, and promote investor choice. Although these benefits are desirable, such arrangements must be applied in a way that protects local investors adequately, prevents financial market integrity from being compromised and addresses systemic risks. Mutual recognition and substituted compliance processes are regulatory tools that reduce regulatory frictions, while ensuring Australian regulatory standards are not weakened.

Most Australian regulators have transparent guidelines for their approach to mutual recognition and substituted compliance.<sup>53</sup> ASIC's general approach is to facilitate access by financial services providers from overseas regulatory regimes that are 'sufficiently equivalent' to the Australian regulatory regime, in terms of the degree of investor protection, market integrity and reduction of systemic risk they achieve. The factors considered are clear and transparent and have been the subject of consultation.

Under ASIC's Principles, it can exempt financial services providers from domestic licensing. This is allowed where the financial services are overseen by an overseas regulatory authority whose regulatory regime is sufficiently equivalent to the Australian regulatory regime, with effective cooperation arrangements between the two regulators.<sup>54</sup> For example, under this arrangement, relief has been given to wholesale service providers from the United Kingdom, United States, Singapore, Hong Kong and Germany.

A reverse example of substituted compliance was RBA's clarification on Australia's regulatory regime for Australian Securities Exchange (ASX) clearing services, which assisted the European Securities and Markets Authority's recognition of Australia's regulatory regime as equivalent – a necessary pre-condition for ASX to continue to offer clearing services to European Union banks.<sup>55</sup>

Mutual recognition has been applied between Australia and New Zealand on trans-Tasman mutual recognition of securities offerings. The regime allows issuers from either country to offer securities, including shares and debentures, or interests in managed investment schemes in the other country, using their home prospectus or Product Disclosure Statement, without complying with most of the substantive requirements of the host jurisdiction.

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- 53 ASIC 2012, *Regulatory Guide 54, Principles for cross-border financial regulation*, ASIC, Sydney, viewed 21 June 2014, <[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg54-published-29-June-2012.pdf/\\$file/rg54-published-29-June-2012.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg54-published-29-June-2012.pdf/$file/rg54-published-29-June-2012.pdf)>. See also Reserve Bank of Australia 2014, *Assessing the Sufficient Equivalence of an Overseas Regulatory Regime*, RBA, Sydney, viewed 21 June 2014, <<http://www.rba.gov.au/payments-system/clearing-settlement/standards/overseas-equivalence.html>>.
- 54 ASIC 2012, *Regulatory Guide 54, Principles for cross-border financial regulation*, ASIC, Sydney, viewed 21 June 2014, <[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg54-published-29-June-2012.pdf/\\$file/rg54-published-29-June-2012.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg54-published-29-June-2012.pdf/$file/rg54-published-29-June-2012.pdf)>.
- 55 European Securities and Markets Authority (ESMA) 2013, *Final report Technical advice on third country regulatory equivalence under EMIR – Australia*, ESMA, Brussels, viewed 21 June 2014, <[http://www.esma.europa.eu/system/files/2013-1159\\_technical\\_advice\\_on\\_third\\_country\\_regulatory\\_equivalence\\_under\\_emir\\_australia.pdf](http://www.esma.europa.eu/system/files/2013-1159_technical_advice_on_third_country_regulatory_equivalence_under_emir_australia.pdf)>.

This arrangement has improved time to market and reduced legal and documentation costs for some issuers by 55 to 95 per cent. From 30 June 2008 to 15 March 2013, the number of offers made under the regime was 66 New Zealand offers to Australia and 834 Australian offers to New Zealand.<sup>56</sup>

Submissions note that as the volume of international regulation increases, processes that allow timely, comprehensive and effective mutual recognition and substituted compliance processes with priority jurisdictions will be of increasing importance.

Submissions seek to ensure that:

- Government and regulatory agencies have appropriate powers to enter mutual recognition or substituted compliance arrangements
- Government and regulatory agencies have considered when unilateral recognition is appropriate without mirror concessions for Australian businesses entering foreign jurisdictions
- Existing mutual recognition guidance and processes are reviewed to ensure they are well positioned to facilitate industry-led approaches for regulatory assessments – particularly to promote access to Australia’s wholesale markets
- Existing arrangements are regularly reviewed to ensure there continues to be equivalence and adequate regulatory cooperation, and that the arrangements remain appropriate
- Current regulatory recognition arrangements receive regular stocktakes to identify priority jurisdictions and activities that might benefit from further arrangements

## Funds – mutual recognition

Managed investment schemes are a significant feature of the Australian financial system landscape and throughout Asia. However, foreign investment in Australian managed investment schemes is very low. In March 2014 it was 3.4 per cent,<sup>57</sup> while it was over 60.0 per cent in Hong Kong<sup>58</sup> and approximately 80.0 per cent in Singapore.<sup>59</sup>

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56 ASIC 2014, First round submission to the Financial System Inquiry, page 26.

57 Australian Bureau of Statistics (ABS) 2014, *Managed Funds, Australia, Mar 2014*, cat. no. 5655.0, ABS, Canberra.

58 Securities and Futures Commission (SFC) 2013, *Fund Management Activities Survey 2012*, SFC, Hong Kong, viewed 19 June, <[http://www.sfc.hk/web/files/ER/PDF/FMAS%202012\\_Report\(Eng\)\\_Final%20on%2025%20Jul%202013.pdf](http://www.sfc.hk/web/files/ER/PDF/FMAS%202012_Report(Eng)_Final%20on%2025%20Jul%202013.pdf)>.

59 Monetary Authority of Singapore 2012, *Singapore Asset Management Industry Survey*, Monetary Authority of Singapore, Singapore, viewed 19 June,

A number of submissions suggest reducing barriers to offering managed investment scheme products internationally to attract interest in Australian managed funds. Industry submissions indicate major impediments are the unique structure of the Australian managed investment scheme and the uniqueness of Australian regulation of collective investments.<sup>60</sup>

The Asian Funds Passport is being developed to address these concerns. The Passport is a mutual recognition agreement for managed investment schemes. It will allow a fund registered in its home economy to be offered in other participating countries, without different operational and licensing requirements.<sup>61</sup> In originally recommending the Passport, the Johnson report identified the European Undertakings for the Collective Investment of Transferable Securities (UCITS) framework as an example of a successful multilateral funds passport arrangement.

The Passport is a significant first step to better integrating the funds management industry in the region. While supporting its progress, the Inquiry also notes that a number of initiatives are currently in place or in motion, designed to establish fund regulatory structures that can promote funds to be offered across borders. They include three proposals emanating from Asia, in addition to the UCITS structure recognised throughout Europe and in wide use in Asia.

#### *Policy options for consideration*

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:*

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

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<http://www.mas.gov.sg/~media/MAS/News%20and%20Publications/Surveys/Asset%20Management/2012%20AM%20Survey%20Public%20Report%20FINAL.pdf>.

- 60 The Corporations and Markets Advisory Committee (CAMAC) has also reviewed the operation of managed investment scheme laws and discussed its possible impediment to international integration. CAMAC 2014, *Managed investment schemes*, CAMAC, Canberra, viewed 19 June 2014, <http://www.camac.gov.au/camac/camac.nsf/byHeadline/Whats+NewMIS+DP+Media+Release+March+2014?openDocument>.
- 61 Corman, M (Acting Assistant Treasurer) 2014, *Asia Region Funds Passport to drive financial services export growth*, viewed 19 June 2014, <http://mhc.ministers.treasury.gov.au/media-release/005-2014/>.

*The Inquiry seeks further information on the following areas:*

- What changes can be made to make implementing international standards more transparent and otherwise improved?
- What improvements could be made to domestic regulatory process to have regard to foreign regulatory developments impacting Australia?
- Are there priority jurisdictions and activities that might benefit from further mutual recognition or other arrangements? What are the identified costs and benefits that might accrue from such an arrangement?

## Coordination of financial integration

### Preliminary assessment

*Observation*

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

### Stakeholders' concerns

Although greater financial integration is not without risk, a number of inquiries have recommended removing impediments to greater integration and fostering mutual recognition, particularly within the Asian region. Government has generally responded positively to these recommendations, but implementation has been slow and is not always well coordinated across Government, regulators and industry.

Given the continuing level of change forecast in the region, it is important to improve Australia's coordination effort.

Stakeholders have suggested an expanded role for the CFR to provide oversight and direction in negotiating and implementing global regulatory standards.

Other specific suggestions and areas of concern raised in submissions include:

- Better planning to deal with simultaneous domestic and international regulatory changes involving multiple agencies<sup>62</sup>
- Giving a Treasury Minister responsibility for championing Australia’s financial services, both within Government and externally, and for working with state counterparts to coordinate policies to promote Australia’s financial sector<sup>63</sup>
- Dedicating a Government resource to focus on competitiveness issues, with the authority to generate legislation quickly and effectively to significantly improve Australia’s competitiveness<sup>64</sup>
- Improving communication and feedback between the market and financial policy advisers by having a standing body that provides:
  - Policy-relevant information to the Treasurer on market developments globally
  - Advice to Treasury on likely market response and reaction to policy proposals under consideration
  - Policy proposals on issues it considers critical to the efficient and effective operation of financial markets
  - Policy advice on an ad hoc basis at the request of Treasury<sup>65</sup>

### Advisory and oversight bodies

A number of bodies already consider Australia’s position in the broader international financial system. Some of these bodies consist solely of representatives in Australia, while others are part of an international infrastructure.

#### Council of Financial Regulators

CFR is the coordinating body for Australia’s main financial regulatory agencies. It is a non-statutory body whose role is to contribute to the efficiency and effectiveness of financial regulation and promote the stability of the Australian financial system. Chaired by the RBA, its membership further comprises APRA, ASIC and Treasury.<sup>66</sup>

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62 ANZ 2014, First round submission to the Financial System Inquiry.

63 Australian Financial Markets Association 2014, First round submission to the Financial System Inquiry.

64 Financial Services Council 2014, First round submission to the Financial System Inquiry.

65 Johnson, M 2014, First round submission to the Financial System Inquiry.

66 Commonwealth Government 2014, *Home page*, Council of Financial Regulators, Sydney, viewed 21 June 2014, <<http://www.cfr.gov.au>>.

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The CFR considers a range of international regulatory reforms, such as the regulatory framework for financial markets infrastructure. As noted in the *Regulatory architecture* chapter, the Inquiry is seeking feedback on increasing the role, transparency and external accountability mechanisms of the CFR.

### **Financial Sector Advisory Council (FSAC)**

FSAC was established following a recommendation from the Wallis Inquiry. The Wallis Inquiry specifically noted the Council should focus on the international competitiveness of Australia's financial sector and how Australia could become a preferred location for financial activities in the region.<sup>67</sup>

FSAC's mandate is to advise the Treasurer on policies that will maintain an efficient, competitive and dynamic financial sector, consistent with the objectives of fairness, financial stability and prudence.

### **APEC Business Advisory Council (ABAC)**

ABAC comprises three business leaders from each of the 21 APEC economies. It advises on issues on APEC's agenda of importance to businesses in the region. Each year, the Council meets with APEC leaders, including the ministers responsible for major sectoral policy issues. Under ABAC's auspices, the Asia Pacific Finance Forum has been established to advise on financial market regulatory developments and market integration in the Asia Pacific.

### **Business 20 (B20)**

The B20 is an international forum of private sector leaders that produces policy recommendations for the annual meeting of the G20 leaders. Australia is chairing the B20 in 2014.

## Policy options for consultation

Australia's coordination efforts across industry, regulators and Government could be improved through amending the remit of one of these or another existing body, or establishing an industry-led body.

However, any changes to existing arrangements would need to be clearly defined and realistic expectations established on the body's scope and influence. The Commission of Audit provided a blunt assessment of the status of Australia's Government bodies and coordination efforts:

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<sup>67</sup> Wallis Recommendation 110.

*There are too many government bodies in Australia. This leads to duplication and overlap, unnecessary complexity, a lack of accountability, the potential for uncoordinated advice and avoidable costs.*<sup>68</sup>

### Elements for coordination body

A number of the submissions discuss the critical elements for a body of this type to be effective. Some submissions note the importance of senior industry representation and significant international experience. The importance of Government involvement is discussed and the involvement of regulators, including those with competition and taxation mandates, is considered crucial for a whole-of-Government perspective. Accountability mechanisms are important to ensure transparency and reporting on progress and to ensure appropriate levels of Government support.

Submissions were split about whether such a body should be funded by industry or Government.

Taking into account the issues raised in *Impediments to financial integration* and *Cross-border regulatory settings*, a coordinating body mandate might include the following responsibilities:

- Providing input to regulators at the time of formation of policies and standards – including in relation to international standards and other international regulation
- Providing input to coordinate policy formulation and position for regional change
- Providing guidance to Government about where future Government engagement efforts are required

*The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*

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

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<sup>68</sup> Commonwealth of Australia 2014, *Towards Responsible Government, The Report of the National Commission of Audit, February 2014, Phase One*, National Commission of Audit, Canberra, page 204, viewed 21 June 2014, <[http://www.ncoa.gov.au/report/docs/phase\\_one\\_report.pdf](http://www.ncoa.gov.au/report/docs/phase_one_report.pdf)>.

*The Inquiry seeks further information on the following areas:*

- Have appropriate elements been put forward for an effective coordination body?
- What role should industry play in any new coordination body, including its funding?

# Appendix 1:

## Terms of reference

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The Treasurer, the Hon Joe Hockey announced the final terms of reference for the Financial System Inquiry on 20 December 2013. The terms of reference are set out below.

### Objectives

The Inquiry is charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth.

Recommendations will be made that foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users.

### Terms of reference

1. The Inquiry will report on the consequences of developments in the Australian financial system since the 1997 Financial System Inquiry and the global financial crisis, including implications for:
  1. how Australia funds its growth;
  2. domestic competition and international competitiveness; and
  3. the current cost, quality, safety and availability of financial services, products and capital for users.
2. The Inquiry will refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including:
  1. balancing competition, innovation, efficiency, stability and consumer protection;
  2. how financial risk is allocated and systemic risk is managed;
  3. assessing the effectiveness and need for financial regulation, including its impact on costs, flexibility, innovation, industry and among users;
  4. the role of Government; and

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5. the role, objectives, funding and performance of financial regulators including an international comparison.
3. The Inquiry will identify and consider the emerging opportunities and challenges that are likely to drive further change in the global and domestic financial system, including:
  1. the role and impact of new technologies, market innovations and changing consumer preferences and demography;
  2. international integration, including international financial regulation;
  3. changes in the way Australia sources and distributes capital, including the intermediation of savings through banks, non-bank financial institutions, insurance companies, superannuation funds and capital markets;
  4. changing organisational structures in the financial sector;
  5. corporate governance structures across the financial system and how they affect stakeholder interests; and
  6. developments in the payment system.
4. The Inquiry will recommend policy options that:
  1. promote a competitive and stable financial system that contributes to Australia's productivity growth;
  2. promote the efficient allocation of capital and cost efficient access and services for users;
  3. meet the needs of users with appropriate financial products and services;
  4. create an environment conducive to dynamic and innovative financial service providers; and
  5. relate to other matters that fall within this terms of reference.
5. The Inquiry will take account of the regulation of the general operation of companies and trusts to the extent this impinges on the efficiency and effective allocation of capital within the financial system.
6. The Inquiry will examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and provide observations that could inform the Tax White Paper.

## Appendix 1: Terms of reference

7. In reaching its conclusions, the Inquiry will take account of, but not make recommendations on the objectives and procedures of the Reserve Bank in its conduct of monetary policy.
8. The Inquiry may invite submissions and seek information from any persons or bodies.
9. The Inquiry will consult extensively both domestically and globally. It will publish an interim report in mid-2014 setting out initial findings and seek public feedback. A final report is to be provided to the Treasurer by November 2014.



## Appendix 2: Tax summary

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The Inquiry has identified a number of taxes that distort the allocation of funding and risk in the economy. The *Funding* chapter explores these issues in detail. The Inquiry has also identified other tax issues that may adversely affect outcomes in the financial system. The tax issues listed below should be considered as part of the Tax White Paper process unless they are already under active Government consideration.

<p><b>Issue</b></p>	<p>The tax system treats the returns from some savings vehicles more favourably than others. Interest income from bank deposits and fixed-income securities are taxed at individuals' marginal tax rates. In contrast, salary-sacrificed superannuation is taxed concessionally. The unequal tax treatment of savings vehicles distorts the asset composition of household balance sheets and the broader flow of funds in the economy.</p> <p>The relatively unfavourable tax treatment of deposits and fixed-income securities lowers their attractiveness as savings vehicles and increases the cost of this type of funding.</p> <p>The asymmetric tax treatment of interest costs and other expenses (which are fully tax deductible) and capital gains (which are taxed concessionally) encourages leveraged and speculative investment — particularly in housing. Since the Wallis Inquiry, higher housing debt has been accompanied by a greater exposure to mortgages by lenders. The housing market has become a significant source of risk for the financial system and the economy.</p> <p>The case for retaining dividend imputation is less clear than it was in the past. By removing the double taxation of corporate earnings, the introduction of dividend imputation reduced the cost of equity, and so contributed to the general decline in leverage among non-financial corporates. However, the benefits of dividend imputation, particularly in lowering the cost of capital, have arguably declined as Australia's economy has become more open.</p> <p>The dividend imputation system creates a bias for individuals and institutional investors, including superannuation funds, to invest in domestic equities. As such, dividend imputation may be affecting the development of the domestic corporate bond market.</p> <p>Mutuals cannot distribute franking credits, unlike institutions with more traditional company structures, which could be affecting competition in banking.</p> <p>Venture Capital Limited Partnerships are taxed concessionally, but the complex tax rules may be a barrier to fund raising. A recent Board of Taxation review (<i>Review of Taxation Arrangements under the Venture Capital Limited Partnerships Regime</i>) made recommendations to simplify the regime.</p> <p>Although the same tax settings apply to all superannuation funds, different tax outcomes between self-managed superannuation funds (SMSFs) and APRA-regulated funds may encourage individuals to establish SMSFs.</p> <p>Legacy products are financial products that are outdated and closed. These include life insurance policies and interests in managed investment schemes. Legacy products are a drag on the efficiency of product providers, which may ultimately lead to higher costs for consumers. In 2009, Treasury proposed a framework for rationalising legacy products, however, this has not yet led to a solution that has been implemented. One significant issue was the tax treatment of underlying assets upon the conversion or consolidation of legacy products into products with equivalent features or benefits.</p>
<p>Differentiated tax treatment of savings vehicles</p>	
<p>Negative gearing and capital gains tax</p>	
<p>Dividend imputation</p>	
<p>Tax treatment of Venture Capital Limited Partnerships</p>	
<p>Tax treatment of superannuation funds</p>	
<p>Tax treatment of legacy products</p>	

<p><b>Issue</b></p>	<p>IWT may distort the funding decisions of financial institutions and place Australia at a competitive disadvantage internationally.</p> <p>Deductions for interest paid by a bank branch of a foreign-owned bank and located in Australia to its parent are capped at the LIBOR rate. This can prevent the Australian branch from claiming the full interest cost of borrowing.</p> <p>Australia is one of the few countries to apply IWT to central clearing parties. This may be placing Australia at a competitive disadvantage when trading derivatives globally.</p> <p>GST is not levied on most financial services. This may contribute to the financial system being larger than it might otherwise be. Financial service providers that do not charge GST still must pay GST on inputs, but cannot claim input tax credits. Providers pass this cost on to consumers in the form of higher prices.</p> <p>As a result, households could be over-consuming financial services compared to what they otherwise would if GST was applied to these services. Because the GST is embedded in prices charged to businesses but not charged explicitly, businesses cannot claim input tax credits and therefore pay a higher price for financial services, which would lead them to consume less financial services than they otherwise would.</p> <p>The R&amp;D Tax Incentive provides businesses with tax credits for eligible R&amp;D costs. The tax credits are available to businesses on an annual basis. Particularly for new ventures, access to quarterly R&amp;D tax credits would help alleviate cash flow constraints.</p> <p>Social impact bonds pay returns based on associated investments achieving agreed social outcomes. Concessional tax treatment of social impact bonds could increase investor demand.</p> <p>The Johnson review recommended changes to the tax system to address uncertainty and scope issues with regard to funds management. Some proposed changes have been partially implemented, such as the investment management regime and the new tax system for managed investment trusts. Other changes are being considered by Government, such as the tax treatment of collective investment vehicles.</p> <p>Submissions seek Government support for OBUs and clarification of associated tax rules.</p> <p>Submissions seek clarification of the tax treatment of Islamic finance products and services.</p>
<p>Interest withholding tax (IWT)</p>	
<p>Goods and Services Tax (GST)</p>	
<p>The Research and Development (R&amp;D) Tax Incentive</p>	
<p>Tax treatment of social impact bonds</p>	
<p>Tax treatment of managed funds</p>	
<p>Tax treatment of offshore banking units (OBUs)</p>	
<p>Tax treatment of Islamic financing</p>	



## Appendix 3: Submissions to the Inquiry

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The first round of submissions to the Financial System Inquiry closed on 31 March 2014 and informed the Inquiry's Interim Report.

The Inquiry received over 280 first round submissions on the issues set out in the Inquiry's Terms of Reference. Submissions lodged up until 2 May 2014 are available on the Financial System Inquiry website ([www.fsi.gov.au](http://www.fsi.gov.au)), except where authors requested confidentiality.

The following is a list of people and organisations that made non-confidential first round submissions.

Institute of Actuaries of Australia	Association of Financial Advisers Limited (AFA)	Australian Bankers' Association Inc
Australian Financial Market Association (AFMA)	Association of Independently Owned Financial Professionals (AIOFP)	Australian Catholic Bishops Conference
Allianz Australia Limited		Australian Centre for Financial Studies
American Express Australia Limited	Association of Mining and Exploration Companies (AMEC)	Australian Government Financial Literacy Board
AMP	ASX	Australian Industry Group
ANZ	AT Kearney	
Australian Restructuring Insolvency & Turnaround Association (ARITA)	Atchison Consultants	Australian Institute of Company Directors
	AHL Investments Pty Ltd (Aussie)	Australian Institute of Superannuation Trustees (AIST)
	The Australia Institute	
Association of Superannuation Funds of Australia (ASFA)	Australia Post	Australian Payments Clearing Association (APCA)
Assetsecure Pty Ltd	Australia Ratings Pty Ltd	

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Australian Private Equity & Venture Capital Association Limited (AVCAL)	Bergwald, Andrew	Chi-X Australia Pty Ltd
Australian Prudential Regulation Authority (APRA)	Bird, David	CHOICE
Australian Retail Credit Association (ARCA)	Brotherhood of St Laurence	Cisco Systems Australia Pty Ltd
Australian Retailers Association (ARA)	Brown, Robert	Citizens Electoral Council of Australia
Australian Securities and Investment Commission (ASIC)	Burrell Stockbroking & Superannuation	Coates, Doug
Australian Securitisation Forum	Business Council of Australia	Cohen, Roger
Australian Settlements Limited (ASL)	Business Council of Co-operatives and Mutuals	Coles Supermarkets Australia Pty Ltd
Australian Shareholder's Association (ASA)	Byford, Martin (RMIT)	Commercial Asset Finance Brokers Association of Australia Limited (CAFBA)
Baker, Bruce	CapMX Pty Ltd	Commonwealth Bank of Australia
Baker, Carl	Carter Newell Lawyers	Community Council for Australia (CCA)
Bank of Queensland (BoQ)	Cawley, Dr Adam	Compare the Market
Banki Haddock Fiora	Centre for Policy Development	Consumer Action Law Centre
Bankmecu	Centre for Excellence in Population Ageing Research (CEPAR)	Consumer Credit Legal Centre (NSW)
Barry, Robert	Centre for Law, Markets and Regulation (UNSW)	COTA
Bendigo and Adelaide Bank Limited	CFA Societies Australia	Council of Small Business Australia (COSBOA)
	Challenger Limited	CPA Australia
	CHAMP Private Equity	Credit Ombudsman Service Limited
	Chan & Naylor	
	Chapman Tripp	

### Appendix 3: Submissions to the Inquiry

CSIRO Monash Superannuation Cluster	Financial Ombudsman Service Limited	Hume, Lyn
CSR Limited	Financial Planning Association of Australia	ICI Global
CUA		Impact Investing Australia Ltd
Cullen Capital Pty Ltd	Financial Services Council (FSC)	Industry Super Australia
Cuscal	Financial Services Institute of Australasia (FINSIA)	Infrastructure Australia
Customer Owned Banking Association		ING Direct
de Tarle, Benoit	FirstMac Limited	Innovation Australia
Digital Finance Analytics	Fowler, E M	Institute of Chartered Accountants Australia
DFA Australia Ltd	Franklin, Craig	
Doe, Vince	Friendly Societies of Australia	Institute of Public Accountants
eftpos Payments Australia Limited	Finance Sector Union (FSU) Australia	Insurance Australia Group (IAG)
Elite Wealth Solutions Pty Ltd	Good Shepherd Microfinance and Good Shepherd Youth & Family Services	Insurance Council of Australia
Export Finance and Insurance Corporation (EFIC)	Governance Institute of Australia Ltd	International Stock Exchange Executives Emeriti (ISEEE)
Ferraro, Salvatore	Gray, Jack	International Swaps and Derivatives Association (ISDA)
Fiduciarys Friend Pty Ltd	GreySpark Partners	Jacobs, Alan
Finance Brokers Association of Australia Ltd	Harkness, Leigh	Johnson, Mark and Weir, Geoff
Financial Literacy Australia Ltd	Herbert, Greg	
	Housing Industry Association (HIA)	Johnston, Adam
	HSBC	Jones, Ian
		K&L Gates

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Kajlich, Anti	Marx, Tony	Name withheld
KCG Australia	Master Builders Australia Ltd	Narrow Road Capital
King & Wood Mallesons	MasterCard Australasia	National Financial Services Federation (NFSF)
King, Yasmin	Maxwell, Ian	National Insurance Brokers Association of Australia (NIBA)
Kingsford Smith, Dimity (UNSW)	McAuley, John	
Kourouche, Hind	McNeil, Peter	National Seniors Australia
KPMG	McQueen, Colin	Neave, Barbara
KS Nathan	Members Equity Bank Pty Ltd	Nehme, Marina (UNSW) and Chioatto, Ulysses (UTS)
Law Council of Australia Limited	Menzies, Gordon (UTA) and Chapman, Bruce (ANU)	NSW Business Chamber
LCH.Clearnet Limited	Menzies, Gordon (UTS), Bird, R (UTS) and Dixon, P	NSW Government
Legal Aid NSW	Mercer	Nugent, Des
Leslie, Kenneth (Project ERNA)		O'Brien, John
LIXI Ltd	Mills, Alan	Oxfam Australia
Lynch, Troy	Minister for Small Business	P&N Bank
Macfarlane, Ian	Minter Ellison	Pascuzzo, Patricia
Mackay, Anthony (Max)	Moloney, David	PayPal
Mackinnon, Ronald	Morgij Analytics	Peterson, John
Macquarie Group Limited	Morrow, Bryan	Piper, William
Maddock, Rodney (Monash)	Mortgage and Finance Association of Australia (MFAA)	Property Council of Australia
Mair, Peter	NAB	

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Property Funds Association of Australia	Singh, Supriya (RMIT)	Turnbull, Robert
	SIRCA Limited	Turnbull, Shann
Prudames, Geoff and Ann	Smith, Sophee	Tyro Payments Ltd
PWC Australia	SMSF Owners' Alliance	UniSuper
QBE	SMSF Professionals' Association of Australia	University of Melbourne
QBE Lenders' Mortgage Insurance	Social Ventures Australia	Veritec Solutions
Quinn, Jim	SocietyOne	VFT 2 Project
Raftery, Adrian	Sommerville, Tim	VISA Inc.
RateSetter Australia Pty Limited	Standard & Poor's Ratings Services	Westpac Banking Corporation
Rayner, Frank	Steen, Adam (CSU)	White, Glenn
Redfern Legal Centre	Stockbrokers Association of Australia	Wide Bay Australia Ltd
Regional Banks submission (on behalf of BoQ, Bendigo and Adelaide Bank, ME Bank and Suncorp Bank)	Suncorp Bank	Wilson Asset Management
	Suncorp General Insurance	Yellow Brick Road
Regnan Governance Research and Engagement	Suncorp Life	
Renton, Nigel	Superannuation Consumers' Centre	
Reserve Bank of Australia	Swan, Peter (UNSW)	
RMIT	Switzer Financial Group Pty Ltd	
Roberts, Oliver	TAL Dai-ichi Life Australia Pty Limited	
Schlusser, William	The Treasury	



## **Appendix 4:**

# **Glossary, acronyms and abbreviations**

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### **Acronyms and abbreviations**

**ABA** – Australian Bankers’ Association

**ABAC** – APEC Business Advisory Council

**ACC** – Australian Crime Commission

**ACCC** – Australian Competition and Consumer Commission

**ACSC** – Australian Cyber Security Centre

**ADI** – authorised deposit-taking institution

**AFMA** – Australian Financial Markets Association

**AFSL** – Australian Financial Services Licence

**AGD** – Attorney-General’s Department

**AIFRS** – Australian equivalents to International Financial Reporting Standards

**ALRC** – Australian Law Reform Commission

**AML** – anti-money laundering

**AOFM** – Australian Office of Financial Management

**APEC** – Asia-Pacific Economic Cooperation forum

**APRA** – Australian Prudential Regulation Authority

**ASC** – Australian Securities Commission

**ASD** – Australian Signals Directorate

**ASEAN** – Association of Southeast Asian Nations

**ASIC** – Australian Securities and Investments Commission

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**ASFA** – Association of Superannuation Funds of Australia

**ASX** – ASX Limited or the exchange operated by ASX Limited

**ATM** – automated teller machine

**ATO** – Australian Taxation Office

**AUSTRAC** – Australian Transaction Reports and Analysis Centre

**BCBS** – Basel Committee on Banking Supervision

**BIS** – Bank for International Settlements

**bps** – basis points

**CAMAC** – Corporations and Markets Advisory Committee

**CCPs** – central counterparties

**CCR** – comprehensive credit reporting

**CEPAR** – Centre of Excellence in Population Ageing Research

**CERT** – Computer Emergency Response Team

**CFR** – Council of Financial Regulators

**CGFS** – Committee on the Global Financial System

**CGS** – Commonwealth Government Securities

**CIFR** – Centre for International Finance and Regulation

**CIV** – collective investment vehicle

**CLF** – committed liquidity facility

**COAG** – Council of Australian Governments

**CPSS** – Committee on Payment and Settlement Systems

**CSEF** – crowd-sourced equity funding

**CUBS** – Credit unions and building societies

**CSS** – Cyber Security Strategy

## Appendix 4: Glossary, acronyms and abbreviations

- CSOB** – Cyber Security Operations Board
- CSOC** – Cyber Security Operations Centre
- DB** – defined benefit
- DC** – defined contribution
- DLA** – deferred lifetime annuity
- EFT** – electronic funds transfer
- EMV** – Europay, Mastercard and Visa
- ESMA** – European Securities and Markets Authority
- ETFs** – exchange-traded funds
- FATCA** – Foreign Account Tax Compliance Act (US based legislation)
- FCA** – UK Financial Conduct Authority
- FCS** – Financial Claims Scheme
- FIDO** – Fast Identity Online alliance
- FMI** – financial market infrastructure
- FOFA** – Future of Financial Advice law reform
- FOS** – Financial Ombudsman Service
- FSAC** – Financial Sector Advisory Council
- FSAP** – Financial Sector Assessment Program
- FSB** – Financial Stability Board, formerly the Financial Stability Forum.
- FSF** – Financial Stability Forum (Now the Financial Stability Board)
- FSG** – Financial Services Guide
- FS-ISAC** – US-based Financial Services Information Sharing and Analysis Center
- FSOC** – Financial Stability Oversight Council
- FSR** – Financial Services Reform

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**G20** – Group of Twenty Finance Ministers and Central Bank Governors from 20 major economies

**GDP** – gross domestic product

**GFC** – Global Financial Crisis

**GLAC** – Gone Concern Loss Absorbing Capacity

**GSA** – group self-annuitisation

**GST** – goods and services tax

**HFT** – high-frequency trading

**HQLA** – high-quality liquid assets

**HVCS** – High Value Clearing System operated by Australian Payments Clearing Association Limited.

**IAIS** – International Association of Insurance Supervisors

**IASB** – International Accounting Standards Board

**IDPS** – investor-direct portfolio services

**IMF** – International Monetary Fund

**IMR** – Investment Manager Regime

**IOSCO** – International Organisation of Securities Commissions

**IRB** – internal ratings-based

**IWT** – interest withholding tax

**KYC** – know your client

**LCR** – liquidity coverage ratio

**LIBOR** – London Interbank Offered Rate

**LIF** – life income fund

**LMI** – lenders mortgage insurance

**LVR** – loan-to-valuation ratio

## Appendix 4: Glossary, acronyms and abbreviations

**MAMBO** – Me and My Bank Online

**MIS** – managed investment scheme

**MIT** – managed investment trust

**MLH** – minimum liquidity holdings

**MOU** – memorandum of understanding

**NCC** – National Credit Code

**NCCP Act** – *National Consumer Credit Protection Act 2009*

**NCPFs** – non-cash payment facilities

**NFC** – near field communications

**NISS** – National Identity Security Strategy

**NIST** – US-based Department of Commerce's National Institute of Standards and Technology

**NPP** – New Payments Platform or New Policy Proposal (depending on the context)

**NSFR** – net stable funding ratio

**NTA** – net tangible assets

**OAIC** – Office of the Australian Information Commissioner

**OBPR** – Office of Best Practice Regulation

**OECD** – Organisation for Economic Co-operation and Development

**OTC** – over-the-counter trading

**P2P** – peer-to-peer

**PC** – Productivity Commission

**PDS** – product disclosure statement

**PI** – professional indemnity

**PPFs** – purchased payment facilities

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**PSB** — Payments System Board

**RBA** — Reserve Bank of Australia

**RBNZ** — Reserve Bank of New Zealand

**RE** — responsible entity

**RITS** — Reserve Bank Information and Transfer System

**RMB** — Reminbi, the official currency of the People's Republic of China

**RMBS** — residential mortgage-backed securities

**SAFs** — small APRA funds

**SCCI** — specialist credit card institutions

**SIS Regulations** — Superannuation Industry (Supervision) Regulations 1994

**SG** — superannuation guarantee

**SME** — small and medium enterprises

**SMSF** — Self-managed superannuation fund

**SOA** — Statement of Advice

**SOE** — Statement of Expectations

**SOI** — Statement of Intent

**UCCC** — Uniform Consumer Credit Code

**UCITS** — European Undertakings for the Collective Investment of Transferable Securities

**VCLP** — Venture Capital Limited Partnership

## Glossary

**accumulation phase** – the period of time over which an individual builds the value of their superannuation benefits before retirement.

**account-based pension** – an individual investment account set up with superannuation benefits from which a retiree draws a regular income.

**annuity** – an investment that pays a guaranteed regular income stream.

**Australian Payments Clearing Association Limited (APCA)** – a public company owned by banks, building societies and credit unions with specific accountability for key parts of the Australian payments system, particularly payments clearing operations.

**Australian Paper Clearing System (APCS)** – operated by Australian Payments Clearing Association Limited.

**Asia-Pacific Economic Cooperation forum (APEC)** – APEC was established in 1989 and has become the primary regional vehicle for promoting open trade and practical economic cooperation. It has 21 member countries, including Australia.

**Australian Prudential Regulation Authority (APRA)** – the prudential regulator of the Australian financial services industry that oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance companies, friendly societies, and most members of the superannuation industry.

**Australian Securities and Investments Commission (ASIC)** – the national regulator of corporate entities, with responsibility for market protection and consumer integrity issues across the financial system.

**Austraclear** – a separate legal entity within the ASX Group that solely provides settlement and related depositary services.

**Australian Competition and Consumer Commission (ACCC)** – a Commonwealth statutory authority responsible for ensuring compliance with the *Competition and Consumer Act 2010* (formerly the *Trade Practices Act 1974*) and the provisions of the Conduct Code. ACCC's consumer protection work complements that of State and Territory consumer affairs agencies.

**Australian Financial Markets Association (AFMA)** – an industry body representing about 200 organisations that participate in Australian over-the-counter wholesale financial markets such as those for foreign exchange, interest rate products, financial derivatives, repurchase agreements, commodities, equity and electricity derivatives.

**Australian Office of Financial Management (AOFM)** — the agency responsible for the management of Australian Government debt and certain financial assets. It issues Treasury Bonds, Treasury Indexed Bonds and Treasury Notes, manages the Government's cash balances and invests from time to time in high quality financial assets.

**authorised deposit-taking institution (ADI)** — an institution authorised by APRA to carry on banking business such as a bank, credit union or building society.

**Basel I, II, III standards** — the Basel Committee on Banking Supervision standards governing internationally active banks.

**BCBS** — Basel Committee on Banking Supervision (**BCBS**) — provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide.

**BPAY** — a payments clearing organisation owned by a group of retail banks. Individuals who hold accounts with a BPAY participating financial institution can pay billing organisations which participate in BPAY, using account transfers initiated by phone or internet. The transfers may be from savings, cheque or credit card accounts.

**Council of Financial Regulators (CFR)** — the coordinating body for Australia's main financial regulatory agencies — RBA, APRA, ASIC and Treasury. CFR's role is to contribute to the efficiency and effectiveness of financial regulation and to promote stability of the Australian financial system.

**Committee on the Global Financial System (CGFS)** — a committee of the BIS that seeks to support central banks in developing appropriate policy recommendations in relation to financial stability, intermediation and transparency.

**Committed Liquidity Facility (CLF)** — the CLF is part of Australia's implementation of the Basel III liquidity reforms. It enables some ADIs to access a pre-specified amount of liquidity by entering into repurchase agreements with the RBA using securities deemed eligible by the RBA.

**Commonwealth Government Securities (CGS)** — debt obligations of the Australian Government evidenced by the issue of securities. The vast bulk of the CGS on issue is represented by Treasury Bonds and Treasury Indexed Bonds.

**consumer price index (CPI)** — a general measure of price inflation for the household sector compiled and published by the Australian Bureau of Statistics.

**defined benefit (DB) superannuation** — a superannuation scheme where contributions are pooled. Benefits are calculated using a predetermined formula, and depend on an individual's salary or wage and length of service.

**defined contribution (DC) superannuation** – a superannuation scheme where contributions are made, and investment earnings accrue, in an individual’s account over their working life. Benefits in retirement are the balance of the account.

**derivative** – a financial contract whose value is based on, or derived from, another financial instrument (such as a bond or share) or a market index (such as the Share Price Index). Examples of derivatives include futures, forwards, swaps and options.

**eftpos** – electronic funds transfer at point of sale. The eftpos system is a domestic debit card system managed by eftpos Payments Australia Limited.

**equity market** – a market where investors buy and sell securities providing ownership of a company’s shares.

**exchange rates** – the price of one currency expressed in terms of another currency. Any exchange rate can be quoted two ways, e.g. Australian dollars per US dollar (USD/AUD) or US dollars per Australian dollar (AUD/USD). The convention for the Australian dollar is that it is quoted as the foreign currency price of the Australian dollar.

**exchange-traded funds (ETFs)** – types of managed funds that can be bought and sold like shares and track the performance of a specified index or benchmark (such as the S&P/ASX 200 index), a currency or commodity, or other assets.

**Financial Claims Scheme (FCS)** – the Australian Government’s guarantee on retail deposits of up to \$250,000 per depositor per ADI.

**financial markets** – a generic term for markets in which financial instruments are traded. The four main financial markets trade in foreign exchange, fixed interest or bonds, shares or equities, and derivatives.

**Financial Sector Assessment Program (FSAP)** – a joint International Monetary Fund (IMF) and World Bank program, seeking to identify the strengths and vulnerabilities of countries’ financial systems, and to determine how key sources of risks are being managed.

**Financial Stability Board (FSB)** – formerly the Financial Stability Forum. The FSB was formed in April 2009 as the re-establishment of the Financial Stability Forum (FSF), which had existed since 1999. The FSB has a mandate to assess the vulnerabilities affecting the financial system, identify and oversee action to address them, and promote co-operation and information sharing among authorities responsible for financial stability. Its membership comprises the G20 countries such as Australia.

**financial market infrastructure (FMI)** — the channels through which financial transactions are cleared, settled and recorded, including payments systems and trading platforms.

**Future of Financial Advice (FOFA)** — regulatory reforms relating to financial advice that commenced in mid-2013. These reforms included the introduction of the ‘best interests’ duty and a ban on conflicted remuneration.

**gross domestic product (GDP)** — a measure of the value of economic production in the economy.

**Investor-direct portfolio services (IDPS)** — for acquiring and holding investments that generally involves custody arrangements and consolidated reporting to investors. The service is typically marketed as a master fund or wrap account.

**International Monetary Fund (IMF)** — is an international organisation of 188 member countries that was established to promote international monetary co-operation, exchange stability, and orderly exchange arrangements; foster economic growth and high levels of employment; and provide temporary financial assistance to countries to help ease balance of payments adjustments.

**interest rate spreads** — the difference between the average yield a financial institution receives from loans and other interest-accruing activities and the average rate it pays on deposits and borrowings — an important determinant of profitability.

**International Organisation of Securities Commissions (IOSCO)** — an international organisation whose members co-operate to promote high standards of regulation in order to protect investors and ensure that markets are fair, efficient and transparent.

**internal ratings-based (IRB)** — an approach allowed under the Basel II guidelines, where major banks use their own risk models to calculate risk weights for the purposes of regulatory capital requirements.

**Know Your Client (KYC)** — customer identity verification requirements applied under anti-money laundering legislation.

**leverage** — the amount of debt used to finance an asset. A firm with significantly more debt than equity is considered to be highly leveraged.

**liquidity** — the capacity to sell an asset quickly without significantly affecting the price of that asset. Liquidity is also sometimes used to refer to assets that are highly liquid.

**liquidity coverage ratio (LCR)** — the Basel III liquidity standard requires ADIs to hold a level of high-quality liquid assets, such as reserves with the central bank or government securities, sufficient in size to cover estimated net cash outflows in a severe liquidity stress.

**liquidity management** – activities within a financial institution to ensure that holdings of liquid assets (e.g. cash, bank deposits and other financial assets) are sufficient to meet its obligations as they fall due, including unexpected transactions.

**longevity risk** – the uncertainty about how long a particular person (or group of people) will live. For an individual, it is the risk of outliving their savings. For providers of guaranteed retirement income products, it is the risk recipients will live longer, and draw more benefits, than the provider has allowed for.

**lump sum** – an amount of a superannuation benefit paid to a fund member as a stand-alone cash amount. Benefits can be paid as one or more lump sums.

**memorandum of understanding (MOU)** – an agreement between two or more parties setting out responsibilities and obligations on matters of common interest. For example, MOUs exist between the Reserve Bank of Australia, Australian Prudential Regulation Authority and Australian Securities and Investments Commission.

**monetary policy** – the setting of an appropriate level of the cash rate target by the Reserve Bank of Australia to maintain the rate of inflation in Australia between 2 and 3 per cent per annum on average over the business cycle.

**MySuper** – low-cost, simple default superannuation accounts, established as part of the Stronger Super reforms announced in 2011.

**Organisation for Economic Co-operation and Development (OECD)** – regarded as representing industrial market countries. It seeks to encourage economic growth, high employment and financial stability among member countries and contribute to the economic development of less-advanced members and non-member countries.

**Payments System Board (PSB)** – created in 1998, within the Reserve Bank of Australia (RBA). The PSB is responsible for determining the RBA's payments system policy so as to best contribute to: controlling risk in the financial system; promoting the efficiency of the payments system; and promoting competition in the market for payment services, consistent with the overall stability of the financial system. Powers to carry out the PSB's policies are vested with the RBA.

**platforms** – administrative services made available by intermediaries for the holding, dealing and viewing of investments selected by individual investors. They provide the capability for investors to choose investment products and generally offer a range of tools to analyse investment portfolios.

**Reserve Bank of Australia (RBA)** – Australia's central bank.

**retirement phase (or decumulation phase)** – the period after an individual has retired from the workforce and qualifies for, and may be in receipt of, superannuation benefits.

**securitisation** — asset securitisation is the process of converting a pool of illiquid assets, such as residential mortgages, into tradeable securities.

**Self-managed superannuation fund (SMSF)** — a superannuation fund with fewer than five members, all of whom are trustees (or directors of a corporate trustee).

**small and medium-enterprise (SME)** — there are a range of definitions for SMEs based on number of employees, turnover and other factors, but in essence the term relates to businesses that are not large businesses.

**Superstream** — a Stronger Super reform to be implemented on a transitional basis starting from 1 July 2014. The reform is aimed at improving the efficiency of the superannuation system. Under SuperStream, employers must make super contributions on behalf of their employees by submitting data and payments electronically in accordance with the SuperStream standard. All superannuation funds, including SMSFs, must receive contributions electronically in accordance with this standard.