

Financial System Inquiry

Final Report

November 2014

© Commonwealth of Australia 2014

ISBN 978-1-925220-14-8

This publication is available for your use under a Creative Commons Attribution 3.0 Australia licence, with the exception of the Commonwealth Coat of Arms, the Treasury logo, photographs, images, signatures and where otherwise stated. The full licence terms are available from <http://creativecommons.org/licenses/by/3.0/au/legalcode>.



Use of Treasury material under a Creative Commons Attribution 3.0 Australia licence requires you to attribute the work (but not in any way that suggests that the Treasury endorses you or your use of the work).

Treasury material used 'as supplied'.

Provided you have not modified or transformed Treasury material in any way including, for example, by changing the Treasury text; calculating percentage changes; graphing or charting data; or deriving new statistics from published Treasury statistics – then Treasury prefers the following attribution:

Source: The Australian Government the Treasury.

Derivative material

If you have modified or transformed Treasury material, or derived new material from those of the Treasury in any way, then Treasury prefers the following attribution:

Based on The Australian Government the Treasury data.

Use of the Coat of Arms

The terms under which the Coat of Arms can be used are set out on the It's an Honour website (see www.itsanhonour.gov.au).

Other Uses

Inquiries regarding this licence and any other use of this document are welcome at:

Manager
Communications
The Treasury
Langton Crescent Parkes ACT 2600
Email: medialiaison@treasury.gov.au

Contents

Foreword	vii
Background to the Inquiry.....	vii
Financial System Inquiry Terms of Reference.....	vii
Financial System Inquiry Committee.....	ix
International Advisory Panel.....	xi
Acknowledgements.....	xi
Executive summary	xiii
Overview and general themes.....	xiv
<i>Chapter 1: Resilience</i>	xvii
<i>Chapter 2: Superannuation and retirement incomes</i>	xviii
<i>Chapter 3: Innovation</i>	xix
<i>Chapter 4: Consumer outcomes</i>	xx
<i>Chapter 5: Regulatory system</i>	xx
<i>Appendix 1: Significant matters</i>	xxi
<i>Appendix 2: Tax summary</i>	xxi
Recommendations.....	xxi
Overview	1
The Australian context.....	2
Characteristics of a well-functioning financial system.....	3
The Inquiry's approach to financial system regulation.....	8
Themes of this report.....	12
Conclusion.....	30
Chapter 1: Resilience	33
Strength in the financial system.....	34
Recommended actions.....	35
Principles.....	37
Conclusion.....	38
Capital levels.....	41
Narrow mortgage risk weight differences.....	60
Loss absorbing and recapitalisation capacity.....	67
Transparent reporting.....	76
Crisis management toolkit.....	79
Financial Claims Scheme.....	82
Leverage ratio.....	84
Direct borrowing by superannuation funds.....	86
Chapter 2: Superannuation and retirement incomes	89
Recommended actions.....	90

Financial System Inquiry — Interim Report

Principles.....	94
Conclusion	94
Objectives of the superannuation system	95
Improving efficiency during accumulation.....	101
The retirement phase of superannuation.....	117
Choice of fund	131
Governance of superannuation funds.....	133
Taxation of superannuation.....	137
Chapter 3: Innovation.....	143
Recommended actions	144
Principles.....	146
Conclusion	146
Collaboration to enable innovation	147
Digital identity.....	151
Clearer graduated payments regulation.....	161
Interchange fees and customer surcharging.....	168
Crowdfunding.....	177
Data access and use.....	181
Comprehensive credit reporting.....	190
Chapter 4: Consumer outcomes.....	193
Recommended actions	194
Principles.....	197
Conclusion	197
Strengthen product issuer and distributor accountability	198
Introduce product intervention power	206
Facilitate innovative disclosure.....	213
Align the interests of financial firms and consumers.....	217
Raise the competency of advisers	222
Improve guidance and disclosure in general insurance	227
Chapter 5: Regulatory system	233
Recommended actions	235
Principles.....	238
Conclusion	238
Regulator accountability	239
Execution of mandate	246
Strengthening Australian Securities and Investments Commission’s funding and powers	250
Strengthening the focus on competition in the financial system.....	254
Compliance costs and policy processes	257
Appendix 1: Significant matters.....	261
Funding	261

Superannuation and retirement incomes	267
Innovation	268
Consumer outcomes	271
Regulatory system	273
Appendix 2: Tax summary	277
Appendix 3: Small and medium-sized enterprises (SMEs)	283
Appendix 4: Consultation.....	285
Approach to the Inquiry.....	285
Consultation.....	285
Submissions to the Inquiry	287
Appendix 5: Glossary, acronyms and abbreviations.....	309
Acronyms and abbreviations	309
Glossary.....	315



28 November, 2014

The Hon Joe Hockey MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

Financial System Inquiry Final Report

In accordance with the Terms of Reference, we are pleased to present the Final Report of the Financial System Inquiry.

The Report provides a blueprint for the future of the Australian financial system. Australia's financial system, while possessing many strong characteristics, has room for improvement.

The Report makes recommendations to promote the efficiency, resilience and fairness of the financial system to facilitate the system's role in supporting a vibrant, growing economy that improves the standard of living of all Australians. The recommendations in this Report complement the observations contained in the Interim Report, released earlier this year.

There has been wide public interest in the Inquiry. We received over 6,800 submissions and held hundreds of stakeholder meetings. We met with over 50 financial institutions, market participants and regulators from the United States, the European Union, the United Kingdom, Asia and New Zealand. In our international consultation, many participants noted that a strength of the Australian system was the holding of major periodic independent inquiries into the financial system such as this.

Many individuals and organisations gave considerable time and resources to assist the Inquiry. In particular, we wish to thank the International Advisory Panel for providing a global perspective on financial system effectiveness. Finally, the Committee wishes to acknowledge the excellent support provided by all members of the Secretariat.

Yours sincerely



David Murray
Chair



Kevin Davis
Member



Craig Dunn
Member



Carolyn Hewson
Member



Brian McNamee
Member

Foreword

Background to the 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 the final terms of reference and appointed a Committee, independent of Government, to undertake this task. The members of the Committee are listed on the following pages.

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

On 24 March 2014, the Treasurer appointed an International Advisory Panel (the Panel) to the Inquiry. The Panel's role was to provide the Inquiry with an expert perspective on aspects of the terms of reference, including technological change, Australia's global competitiveness and offshore regulatory frameworks. The members of the Panel are also on the following pages.

Financial System Inquiry Terms of Reference

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;

Financial System Inquiry Terms of Reference (cont.)

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
 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.

Financial System Inquiry Terms of Reference (cont.)

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.
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.

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.

Financial System Inquiry Committee

Mr David Murray AO (Chair)

Mr David Murray AO (Sydney) was most recently the inaugural Chairman of the Australian Government's Future Fund Board of Guardians between 2006 and 2012. Mr Murray was previously the Chief Executive Officer of the Commonwealth Bank of

Financial System Inquiry — Final report

Australia between 1992 and 2005. In this time, Mr Murray oversaw the transformation of the Commonwealth Bank from a partly privatised bank to an integrated financial services company.

In 2001, he was awarded the Centenary Medal for service to Australian society in banking and corporate governance, and in 2007 he was made an Officer of the Order of Australia for his service to the finance sector, both domestically and globally, and service to the community.

Professor Kevin Davis

Professor Kevin Davis (Melbourne) is currently a Professor of Finance at the University of Melbourne, Research Director at the Australian Centre for Financial Studies and a Professor of Finance at Monash University. Professor Davis is also a part-time member of the Australian Competition Tribunal and Co-Chair of the Australia–New Zealand Shadow Financial Regulatory Committee.

Mr Craig Dunn

Mr Craig Dunn (Sydney) was most recently Chief Executive Officer and Managing Director of AMP. Mr Dunn led AMP through the global financial crisis and has extensive experience in the financial sector. He was a member of the Australian Government’s Financial Sector Advisory Council and the Australian Financial Centre Forum, and an executive member of the Australia Japan Business Co-operation Committee. Mr Dunn is a director of the Australian Government’s Financial Literacy Board.

Ms Carolyn Hewson AO

Ms Carolyn Hewson AO (Adelaide) served as an investment banker at Schrodgers Australia for 15 years. Ms Hewson has over 30 years’ experience in the finance sector and currently serves on the boards of BHP Billiton Ltd and Stockland. Ms Hewson was made an Officer of the Order of Australia for her services to the YWCA and to business. Ms Hewson has served on both the boards of Westpac and AMP and retired from the board of BT Investment Management Ltd and as the Chair of the Westpac Foundation upon her appointment to the Financial System Inquiry Committee.

Dr Brian McNamee AO

Dr Brian McNamee AO (Melbourne) served as the Chief Executive Officer and Managing Director of CSL Limited from 1990 to 30 June 2013. During that time, CSL transitioned from a Government-owned enterprise to a global company with a market capitalisation of approximately \$30 billion. He has extensive experience in the biotech and global healthcare industries. Dr McNamee was made an Officer of the Order of Australia for his service to business and commerce.

International Advisory Panel

Sir Michael Hintze AM

Sir Michael Hintze (London) is the founder and Chief Executive Officer of CQS, a global multi-strategy asset management firm. Prior to founding CQS, Sir Michael held senior roles at Credit Suisse First Boston and Goldman Sachs. He was made a Member of the Order of Australia for his support to the arts, health and education, and awarded a knighthood for his philanthropic services to the arts in the United Kingdom.

Dr David Morgan AO

Dr David Morgan (London) is currently the head of private equity group JC Flowers & Co. in Europe and the Asia-Pacific region. Dr Morgan was previously Chief Executive Officer of Westpac Banking Corporation and a deputy secretary of the Australian Treasury, and he has also worked for the International Monetary Fund. He was made an Officer of the Order of Australia in 2009 for his service to the finance sector.

Ms Jennifer Nason

Ms Jennifer Nason (New York) is Global Chairman of Technology, Media and Telecom Investment Banking at JPMorgan Chase & Co. In her 28-year tenure at the bank, Ms Nason worked around the world on mergers, acquisitions, and debt and equity financings, and in strategic advisory roles for technology, media and telecommunications companies.

Mr Andrew Sheng

Mr Andrew Sheng (Hong Kong) is a well-known former central banker and financial regulator in Asia and a leading commentator on global finance. He is a Distinguished Fellow and former President of the Fung Global Institute, a Hong Kong-based global think tank, and previously held senior positions in the Securities and Futures Commission of Hong Kong, the Hong Kong Monetary Authority and the World Bank. In 2013, *TIME* listed Mr Sheng as one of the world's 100 most influential people.

Acknowledgements

The Committee wishes to thank the large number of stakeholders who freely gave their time to make submissions, participate in public consultations and meetings with the Inquiry, or assist with research. The Committee acknowledges the assistance of:

- The public and private sector organisations that provided expertise and resources to the Secretariat.

Financial System Inquiry — Final report

- Treasury, the Reserve Bank of Australia, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Australian Taxation Office.
- The large number of international agencies, regulators and financial system participants that the Committee met with during international consultation.
- Mr Bruce White, the New Zealand observer to the Inquiry.
- The Centre for International Finance and Regulation, and the Australian Centre for Financial Studies.
- Ms Karen Pryor for editing services.

Finally, the Committee wishes to acknowledge the support provided by all members of the Secretariat:

John Lonsdale (Head of Secretariat), Mark Adams, Sarah Alland, Geoff Atkins, Debbie Banerjee, Ian Beckett, Percy Bell, Camille Blackburn, Kylie Bourke, Adam Cagliariini, Lynda Coker, Jason Collins, Andrew Craston, Kathryn Dolan, George Gardner, Glen Granger, Jacob Hook, Darren Kennedy, Amanda Kirby, Suh Mian Ng, Brad Parry, Amber Rowland, Daniel Royal, Luke Spear, Thomas Stapp, Melisande Waterford, Julia Wells, Vicki Wilkinson, Callan Windsor and Chris Zwolinski.

Executive summary

This report responds to the objective in the Inquiry's Terms of Reference to best position Australia's financial system to meet Australia's evolving needs and support economic growth. It offers a blueprint for an efficient and resilient financial system over the next 10 to 20 years, characterised by the fair treatment of users.

The Inquiry has made 44 recommendations relating to the Australian financial system. These recommendations reflect the Inquiry's judgement and are based on evidence received by the Inquiry. The Inquiry's test has been one of public interest: the interests of individuals, businesses, the economy, taxpayers and Government.

Australia's financial system has performed well since the Wallis Inquiry and has many strong characteristics. It also has a number of weaknesses: taxation and regulatory settings distort the flow of funding to the real economy; it remains susceptible to financial shocks; superannuation is not delivering retirement incomes efficiently; unfair consumer outcomes remain prevalent; and policy settings do not focus on the benefits of competition and innovation. As a result, the system is prone to calls for more regulation.

To put these issues in context, the *Overview* first deals with the characteristics of Australia's economy. It then describes the characteristics of and prerequisites for a well-functioning financial system and the Inquiry's philosophy of financial regulation.

The Inquiry focuses on seven themes in this report (summarised in *Guide to the Financial System Inquiry Final Report*). The *Overview* deals with the general themes of funding the Australian economy and competition.

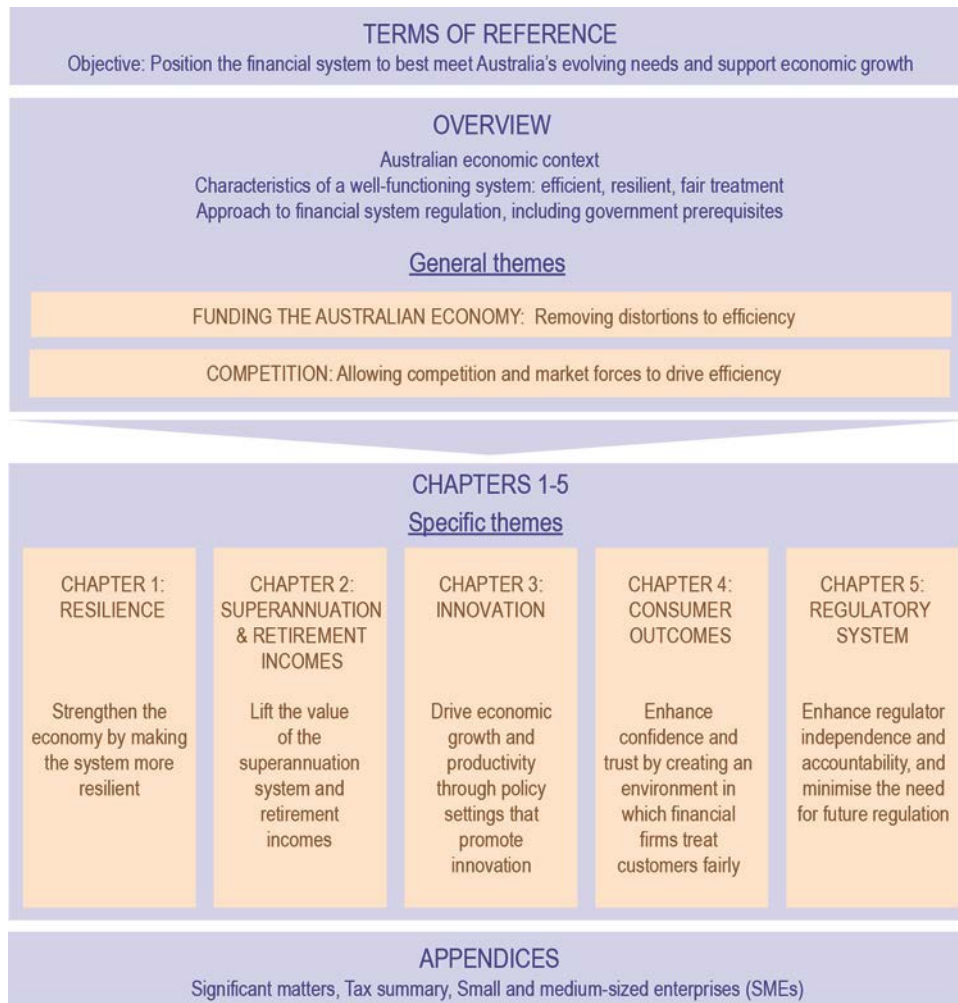
The Inquiry has also made recommendations on five specific themes, which comprise the next chapters of this report:

- Strengthen the economy by making the financial system more resilient.
- Lift the value of the superannuation system and retirement incomes.
- Drive economic growth and productivity through settings that promote innovation.
- Enhance confidence and trust by creating an environment in which financial firms treat customers fairly.
- Enhance regulator independence and accountability, and minimise the need for future regulation.

Financial System Inquiry — Final report

These recommendations seek to improve efficiency, resilience and fair treatment in the Australian financial system, allowing it to achieve its potential in supporting economic growth and enhancing standards of living for current and future generations.

Guide to the Financial System Inquiry Final Report



Overview and general themes

The Inquiry has taken into account important features of Australia's economy. Australia has an open, market-based economy and is a net importer of capital. The Australian economy faces a considerable productivity challenge, and the Australian population, like many around the world, is ageing. Finally, Australia is in the midst of one of the most ubiquitous, generally applicable technology changes the world has ever seen.

Characteristics of an effective financial system

The financial sector plays a vital role in supporting a vibrant, growing economy that improves the standard of living for all Australians. The system's ultimate purpose is to facilitate sustainable growth in the economy by meeting the financial needs of its users. The Inquiry believes the financial system will achieve this goal if it operates in a manner that is:

- **Efficient:** An efficient system allocates Australia's scarce financial and other resources for the greatest possible benefit to our economy, supporting growth, productivity and prosperity.
- **Resilient:** The financial system should adjust to changing circumstances while continuing to provide its core economic functions, even during severe shocks. Institutions in distress should be resolvable with minimal costs to depositors, policy holders, taxpayers and the real economy.
- **Fair:** Fair treatment occurs where participants act with integrity, honesty, transparency and non-discrimination. A market economy operates more effectively where participants enter into transactions with confidence they will be treated fairly.

Confidence and trust in the system are essential ingredients in building an efficient, resilient and fair financial system that facilitates economic growth and meets the financial needs of Australians. The Inquiry considers that all financial system participants have roles and responsibilities in engendering that confidence and trust.

The Inquiry's approach to financial system regulation

Central to the Inquiry's philosophy is the principle that the financial system should be subject and responsive to market forces, including competition.

However, competitive markets need to operate within a strong and effective legal and policy framework provided by Government. This includes predictable rule of law with strong property rights; a freely convertible floating currency and free flow of trade, investment and capital across borders; a strong fiscal position; a sound and independent monetary policy framework; and an effective, accountable and transparent government.

The Inquiry's approach to policy intervention is guided by the public interest. Given the inevitable trade-offs involved, deciding how and when policy makers should intervene in the financial system requires considerable judgement. Intervention should seek to balance efficiency, resilience and fairness in a way that builds participants' confidence and trust. Intervention should only occur where its benefits to the economy as a whole outweigh its costs, and should always seek to be proportionate and cost sensitive.

General themes

The Inquiry identified two general themes where there is significant scope to improve the functioning of the financial system:

1. Funding the Australian economy.
2. Competition.

Funding the Australian economy

The core function of the Australian financial system is to facilitate the funding of sustainable economic growth and enhance productivity in the Australian economy. The Inquiry believes Government's role in funding markets should generally be neutral regarding the channel, direction, source and size of the flow of funds.

The Inquiry identified a number of distortions that impede the efficient market allocation of financial resources, including taxation, information imbalances and unnecessary regulation. Reducing the distortionary effects of taxation should lead the system to allocate savings (including foreign savings) more efficiently and price risk more accurately. The Inquiry has referred the identified tax issues for consideration in the Tax White Paper.

A number of the Inquiry's recommendations aim to assist small and medium-sized enterprises in obtaining better access to funding. To strengthen Australia's ability to continue to access funding, both domestically and from offshore sources, recommendations have been made to improve the resilience of the Australian financial system. More broadly, given that Australia's growing superannuation system will have an increasing influence on future funding flows, the Inquiry believes that the recommendations it has made to improve the efficiency of the superannuation system would also enhance financial system funding efficiency.

Competition

Competition and competitive markets are at the heart of the Inquiry's philosophy for the financial system. The Inquiry sees them as the primary means of supporting the system's efficiency. Although the Inquiry considers competition is generally adequate, the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and should be proactively monitored over time.

The Inquiry's approach to encouraging competition is to seek to remove impediments to its development. The Inquiry has made recommendations to amend the regulatory system, including: narrowing the differences in risk weights in mortgage lending; considering a competitive mechanism to allocate members to more efficient superannuation funds; and ensuring regulators are more sensitive to the effects of their decisions on competition, international competitiveness and the free flow of capital.

In particular, the state of competition in the financial system should be reviewed every three years, including assessing changes in barriers to international competition.

Recommendations relating to funding and competition are listed in Table 1.

Table 1: Funding the Australian economy and competition recommendations

Funding the Australian economy	
Number	Description
–	Tax observations
18	Crowdfunding
19	Data access and use
20	Comprehensive credit reporting
33	Retail corporate bond market
Competition	
Number	Description
2	Narrow mortgage risk weight differences
10	Improving efficiency during accumulation
14	Collaboration to enable innovation
15	Digital identity
16	Clearer graduated payments regulation
18	Crowdfunding
19	Data access and use
20	Comprehensive credit reporting
27	Regulator accountability
30	Strengthening the focus on competition in the financial system
39	Technology neutrality
42	Managed investment scheme regulation

Chapter 1: Resilience

Historically, Australia has maintained a strong and stable financial system supported by effective stability settings. However, the Australian financial system has characteristics that give rise to particular risks, including its high interconnectivity domestically and with the rest of the world, and its dependence on importing capital. More can be done to strengthen the resilience of Australia’s financial system to avoid or limit the costs of future financial crises, which can deeply damage an economy and have lasting effects on people’s lives.

As the banking sector is at the core of the Australian financial system, its safety is of paramount importance. Australia should aim to have financial institutions with the strength to not only withstand plausible shocks but to continue to provide critical

Financial System Inquiry — Final report

economic functions, such as credit and payment services, in the face of these shocks. Adhering to international regulatory norms will help ensure Australian financial institutions and markets are not disadvantaged in raising funds in international financial markets.

The Inquiry's recommendations to improve resilience aim to:

- Strengthen policy settings that lower the probability of failure, including setting Australian bank capital ratios such that they are unquestionably strong by being in the top quartile of internationally active banks.
- Reduce the costs of failure, including by ensuring authorised deposit-taking institutions maintain sufficient loss absorbing and recapitalisation capacity to allow effective resolution with limited risk to taxpayer funds – in line with international practice.

These recommendations seek to ensure that Australia's financial system remains resilient into the future, and that it continues to provide its core economic functions, even in times of financial stress. These recommendations should also produce efficiency benefits, including through reducing implicit guarantees and volatility in the economy and promoting confidence and trust.

Chapter 2: Superannuation and retirement incomes

Australia's superannuation system is large by international standards and has grown rapidly since the Wallis Inquiry, primarily as a result of Government policy settings.

An efficient superannuation system is critical to help Australia meet the economic and fiscal challenges of an ageing population. The system has considerable strengths. It plays an important role in providing long-term funding for economic activity in Australia both directly and indirectly through funding financial institutions, and it contributed to the stability of the financial system and the economy during the global financial crisis.

However, the superannuation system is not operationally efficient due to a lack of strong price-based competition. Superannuation assets are not being efficiently converted into retirement incomes due to a lack of risk pooling and over-reliance on individual account-based pensions.

The Inquiry's recommendations to strengthen the superannuation system aim to:

- Set a clear objective for the superannuation system to provide income in retirement.

- Improve long-term net returns for members by introducing a formal competitive process to allocate new workforce entrants to high-performing superannuation funds, unless the Stronger Super reforms prove effective.
- Meet the needs of retirees better by requiring superannuation trustees to pre-select a comprehensive income product in retirement for members to receive their benefits, unless members choose to take their benefits in another way.

These recommendations seek to improve the outcomes for superannuation fund members and help Australia to manage the challenges of an ageing population.

Chapter 3: Innovation

Technology-driven innovation is transforming the financial system, as evidenced by the emergence of new business models and products, and substantial investment in areas such as mobile banking, cloud computing and payment services.

Although innovation has the potential to deliver significant efficiency benefits and improve system outcomes, it also brings risks. Consumers, businesses and government can be adversely affected by new developments, which may also challenge regulatory frameworks and regulators' ability to respond.

The Inquiry believes the innovative potential of Australia's financial system and broader economy can be supported by taking action to ensure policy settings facilitate future innovation that benefits consumers, businesses and government.

The Inquiry's recommendations to facilitate innovation aim to:

- Encourage industry and government to work together to identify innovation opportunities and emerging network benefits where government may need to facilitate industry coordination and action.
- Strengthen Australia's digital identity framework through the development of a national strategy for a federated-style model of trusted digital identities.
- Remove unnecessary regulatory impediments to innovation, particularly in the payments system and in fundraising for small businesses.
- Enable the development of data-driven business models through holding a Productivity Commission Inquiry into the costs and benefits of increasing access to and improving the use of private and public sector data.

These recommendations will contribute to developing a dynamic, competitive, growth-oriented and forward-looking financial system for Australia.

Chapter 4: Consumer outcomes

Fundamental to fair treatment is the concept that financial products and services should perform in the way that consumers expect or are led to believe.

The current framework is not sufficient to deliver fair treatment to consumers. The most significant problems relate to shortcomings in disclosure and financial advice, which means some consumers are sold financial products that are not suited to their needs and circumstances. Although the regime should not be expected to prevent all consumer losses, self-regulatory and regulatory changes are needed to strengthen financial firms' accountability.

The Inquiry's recommendations to improve consumer outcomes aim to:

- Improve the design and distribution of financial products through strengthening product issuer and distributor accountability, and through implementing a new temporary product intervention power for the Australian Securities and Investments Commission (ASIC).
- Further align the interests of firms and consumers, and improve standards of financial advice, by lifting competency and increasing transparency regarding financial advice.
- Empower consumers by encouraging industry to harness technology and develop more innovative and useful forms of disclosure.

These recommendations seek to strengthen the current framework to promote consumer trust in the system and fair treatment of consumers.

Chapter 5: Regulatory system

Australia needs strong, independent and accountable regulators to help maintain confidence and trust in the financial system, thereby attracting investment and supporting growth. This requires proactive regulators with the right skills, culture, powers and funding.

Australia's regulatory architecture does not need major change; however, the Inquiry has made recommendations to improve the current arrangements. Government currently lacks a regular process that allows it to assess the overall performance of financial regulators. Regulators' funding arrangements and enforcement tools have some significant weaknesses, particularly in the case of ASIC. In addition, it is not clear whether adequate consideration is currently given to competition and efficiency in designing and applying regulation.

The Inquiry's recommendations to refine Australia's regulatory system and keep it fit for purpose aim to:

- Improve the accountability framework governing Australia's financial sector regulators by establishing a new Financial Regulator Assessment Board to review their performance annually.
- Ensure Australia's regulators have the funding, skills and regulatory tools to deliver their mandates effectively.
- Rebalance the regulatory focus towards competition by including an explicit requirement to consider competition in ASIC's mandate and conduct three-yearly external reviews of the state of competition.
- Improve the process for implementing new financial regulations.

These recommendations seek to make Australia's financial regulators more effective, adaptable and accountable.

Appendix 1: Significant matters

In addition to the recommendations in the above areas, the Inquiry has made 13 recommendations relating to other significant matters. These are contained in *Appendix 1: Significant matters*.

Appendix 2: Tax summary

A number of tax observations are included in *Appendix 2: Tax summary* for consideration by the Tax White Paper.

Recommendations

The Inquiry has made 44 recommendations relating to the Australian financial system. The nature of some recommendations warrants more in-depth discussion. These recommendations are shaded darker in the *Summary of recommendations by chapter* tables on the following pages. The Inquiry considers that the remaining recommendations in the body of the report can be made without providing the reader with the same depth of explanation. Recommendations contained in *Appendix 1: Significant matters* are only explained briefly.

Summary of recommendations by chapter

Chapter 1: Resilience (pages 33–88)	
Number	Description
1	Capital levels <i>Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.</i>
2	Narrow mortgage risk weight differences <i>Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.</i>
3	Loss absorbing and recapitalisation capacity <i>Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.</i>
4	Transparent reporting <i>Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework.</i>
5	Crisis management toolkit <i>Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry.</i>
6	Financial Claims Scheme <i>Maintain the ex post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.</i>
7	Leverage ratio <i>Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions' risk-weighted capital positions.</i>
8	Direct borrowing by superannuation funds <i>Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.</i>

Chapter 2: Superannuation and retirement incomes (pages 89–142)	
Number	Description
9	<p>Objectives of the superannuation system</p> <p><i>Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.</i></p>
10	<p>Improving efficiency during accumulation</p> <p><i>Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.</i></p>
11	<p>The retirement phase of superannuation</p> <p><i>Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.</i></p>
12	<p>Choice of fund</p> <p><i>Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.</i></p>
13	<p>Governance of superannuation funds</p> <p><i>Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.</i></p>

Chapter 3: Innovation (pages 143–192)	
Number	Description
14	<p>Collaboration to enable innovation</p> <p><i>Establish a permanent public–private sector collaborative committee, the ‘Innovation Collaboration’, to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.</i></p>
15	<p>Digital identity</p> <p><i>Develop a national strategy for a federated-style model of trusted digital identities.</i></p>
16	<p>Clearer graduated payments regulation</p> <p><i>Enhance graduation of retail payments regulation by clarifying thresholds for regulation by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority.</i></p> <p><i>Strengthen consumer protection by mandating the ePayments Code.</i></p> <p><i>Introduce a separate prudential regime with two tiers for purchased payment facilities.</i></p>
17	<p>Interchange fees and customer surcharging</p> <p><i>Improve interchange fee regulation by clarifying thresholds for when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees.</i></p> <p><i>Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.</i></p>
18	<p>Crowdfunding</p> <p><i>Graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.</i></p>
19	<p>Data access and use</p> <p><i>Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.</i></p>
20	<p>Comprehensive credit reporting</p> <p><i>Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime. If, over time, participation is inadequate, Government should consider legislating mandatory participation.</i></p>

Chapter 4: Consumer outcomes (pages 193–232)	
Number	Description
21	<p>Strengthen product issuer and distributor accountability</p> <p><i>Introduce a targeted and principles-based product design and distribution obligation.</i></p>
22	<p>Introduce product intervention power</p> <p><i>Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.</i></p>
23	<p>Facilitate innovative disclosure</p> <p><i>Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.</i></p>
24	<p>Align the interests of financial firms and consumers</p> <p><i>Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.</i></p>
25	<p>Raise the competency of advisers</p> <p><i>Raise the competency of financial advice providers and introduce an enhanced register of advisers.</i></p>
26	<p>Improve guidance and disclosure in general insurance</p> <p><i>Improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance.</i></p>

Chapter 5: Regulatory system (pages 233–260)	
Number	Description
27	<p>Regulator accountability</p> <p><i>Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates.</i></p> <p><i>Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.</i></p>
28	<p>Execution of mandate</p> <p><i>Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews.</i></p>
29	<p>Strengthening the Australian Securities and Investments Commission’s funding and powers</p> <p><i>Introduce an industry funding model for the Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.</i></p>
30	<p>Strengthening the focus on competition in the financial system</p> <p><i>Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission’s mandate.</i></p>
31	<p>Compliance costs and policy processes</p> <p><i>Increase the time available for industry to implement complex regulatory change.</i></p> <p><i>Conduct post-implementation reviews of major regulatory changes more frequently.</i></p>

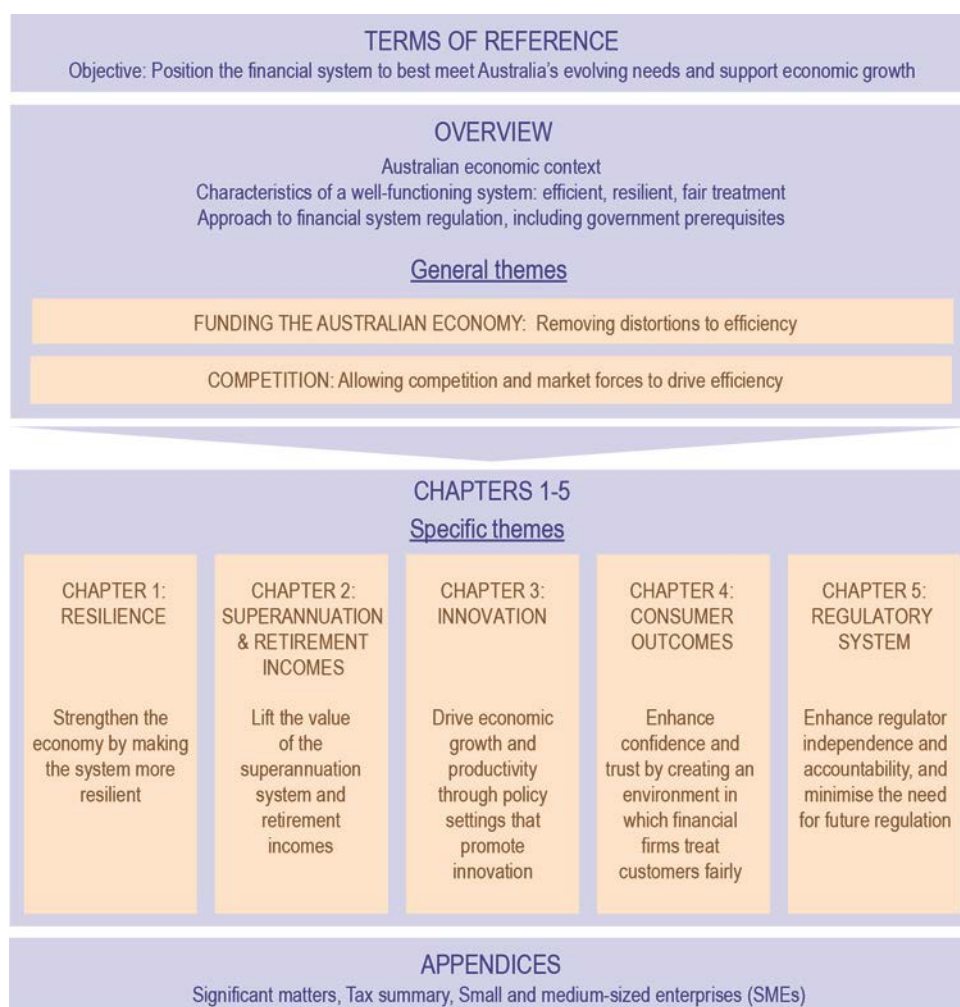
Appendix 1: Significant matters (pages 261–276)	
Number	Description
32	<p>Impact investment</p> <p><i>Explore ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery.</i></p> <p><i>Provide guidance to superannuation trustees on the appropriateness of impact investment.</i></p> <p><i>Support law reform to classify a private ancillary fund as a ‘sophisticated’ or ‘professional’ investor, where the founder of the fund meets those definitions.</i></p>
33	<p>Retail corporate bond market</p> <p><i>Reduce disclosure requirements for large listed corporates issuing ‘simple’ bonds and encourage industry to develop standard terms for ‘simple’ bonds.</i></p>
34	<p>Unfair contract term provisions</p> <p><i>Support Government’s process to extend unfair contract term protections to small businesses.</i></p> <p><i>Encourage industry to develop standards on the use of non-monetary default covenants.</i></p>
35	<p>Finance companies</p> <p><i>Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from authorised deposit-taking institution deposits.</i></p>
36	<p>Corporate administration and bankruptcy</p> <p><i>Consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.</i></p>
37	<p>Superannuation member engagement</p> <p><i>Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance.</i></p> <p><i>Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC’s and superannuation funds’ retirement income projection calculators.</i></p>
38	<p>Cyber security</p> <p><i>Update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation, and progress public–private sector and cross-industry collaboration.</i></p> <p><i>Establish a formal framework for cyber security information sharing and response to cyber threats.</i></p>

Appendix 1: Significant matters (pages 261–276) (cont.)	
Number	Number
39	<p>Technology neutrality</p> <p><i>Identify, in consultation with the financial sector, and amend priority areas of regulation to be technology neutral.</i></p> <p><i>Embed consideration of the principle of technology neutrality into development processes for future regulation.</i></p> <p><i>Ensure regulation allows individuals to select alternative methods to access services to maintain fair treatment for all consumer segments.</i></p>
40	<p>Provision of financial advice and mortgage broking</p> <p><i>Rename ‘general advice’ and require advisers and mortgage brokers to disclose ownership structures.</i></p>
41	<p>Unclaimed monies</p> <p><i>Define bank accounts and life insurance policies as unclaimed monies only if they are inactive for seven years.</i></p>
42	<p>Managed investment scheme regulation</p> <p><i>Support Government’s review of the Corporations and Markets Advisory Committee’s recommendations on managed investment schemes, giving priority to matters relating to:</i></p> <ul style="list-style-type: none"> • <i>Consumer detriment, including illiquid schemes and freezing of funds.</i> • <i>Regulatory architecture impeding cross-border transactions and mutual recognition arrangements.</i>
43	<p>Legacy products</p> <p><i>Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.</i></p>
44	<p>Corporations Act 2001 ownership restrictions</p> <p><i>Remove market ownership restrictions from the Corporations Act 2001 once the current reforms to cross-border regulation of financial market infrastructure are complete.</i></p>

Overview

This chapter provides an overview of the Financial System Inquiry’s Final Report. It sets out the Inquiry’s starting point for considering how the financial system can meet Australia’s evolving needs and support sustainable economic growth. This includes outlining the Australian context in which the Inquiry has made its recommendations, the characteristics of a well-functioning financial system and the Inquiry’s philosophy of financial regulation. This chapter discusses the two general themes that permeate much of the Inquiry’s thinking: the effectiveness of the financial system in funding the economy and the importance of competition in the financial system. It also provides a brief summary of the five specific themes detailed in the remaining chapters of this report.

Figure 1: Guide to the Financial System Inquiry Final Report



The Australian context

In assessing priority areas of financial sector reform, the Inquiry has taken into account the following characteristics of the Australian economy:

- Australia is an open **market-based economy**. The Australian financial system is predominantly privately owned and operates according to market principles.
- Australia is, and is likely to continue to be, a substantial net **importer of capital**. Australia has a relatively small but well-educated and skilled population. It has significant endowments of natural resources that cannot be fully utilised without foreign investment. Ongoing access to foreign funding has enabled Australia to sustain higher growth than it otherwise could. The financial system has an important role in facilitating funding from, and investing in, offshore capital markets.
- The structure of the Australian **economy will continue to evolve**, as seen in the shift from mining-led investment to broader activities in non-mining sectors. The financial system plays an important role in assisting the economy as it adapts to such changes by facilitating the reallocation of financial resources.
- The Australian population, like many around the world, is **ageing**. This trend is likely to result in a lower proportion of the population being of working age, dampening long-term economic growth and placing greater fiscal pressures on governments. In this environment, a well-functioning superannuation system will be important in alleviating these pressures and ensuring good outcomes for retirees.
- The Australian economy faces a considerable **productivity** challenge. Compared with the last decade, productivity growth will need to be stronger to maintain Australia's living standards, as our terms of trade continue their expected decline and the population ages. The financial system plays an important role in facilitating productivity growth by funding the economy more efficiently, including funding new businesses and using new technology.
- With the advent of digital technology, Australia is in the midst of one of the most ubiquitous, generally applicable **technology** changes the world has seen. Its effect has been, and continues to be, revolutionary as innovative business models insert new competitive tensions into a variety of industries. For the financial system, technology-driven innovation will continue to change the financial products offered to consumers and the very nature of financial intermediation.

- Australian **financial system assets have grown** from the equivalent of around two years' worth of nominal gross domestic product (GDP) in 1997 to more than three years' worth of nominal GDP.¹ Compared to international peers, Australia has a relatively large financial system.² In particular, superannuation assets are expected to continue to grow and increasingly influence funding flows in the economy.
- Some sectors of the Australian financial system are **concentrated**. In particular, the banking sector is concentrated, with the four major banks being the largest players in many aspects of the financial system and having significant market influence. Such concentration creates risks to both the stability and degree of competition in the Australian financial system.

Characteristics of a well-functioning financial system

The financial system plays a vital role in supporting sustainable economic growth and meeting the financial needs of Australians. It does this by facilitating funding, liquidity and price discovery, while also providing effective risk management, payment and some monitoring services.

The Inquiry believes the financial system achieves this most effectively when it operates in an **efficient** and **resilient** manner and treats participants **fairly**. This occurs when participants fulfil their **roles and responsibilities** in a way that engenders confidence and trust in the system.

The financial industry makes a considerable contribution to employment and economic output in Australia. However, the Inquiry believes the focus of financial system policy should be primarily on the degree of efficiency, resilience and fairness the system achieves in facilitating economic activity, rather than on its size or direct contribution (such as through wages and profits) to the economy.

1 Reserve Bank of Australia (RBA) 2014, First round submission to the Financial System Inquiry, page 15.

2 Note: This comparison is based on the share of gross value-added terms. Reserve Bank of Australia (RBA) 2014, First round submission to the Financial System Inquiry, pages 17-18.

Efficiency

An efficient financial system is fundamental to supporting Australia's growth and productivity. An efficient system allocates Australia's scarce financial and other resources for the greatest possible benefit to our economy, promoting a higher and more sustainable rate of productivity, and economic growth. The Inquiry is concerned with three distinct, but interrelated, forms of efficiency:

- **Operational efficiency** — where financial products and services are delivered in a way that minimises costs and maximises value. This largely depends on how effectively firms deploy labour, capital and technology, and the regulations with which firms comply. Strong competition, both from new entrants and incumbents, encourages firms to innovate and increase operational efficiency to survive and prosper. This can be seen in the ongoing industry focus on deploying new technologies in the Australian financial system to improve the quality and reduce the cost of products and services. Good policy-making can also assist operational efficiency by providing a stable regulatory environment and well-designed regulation that takes into account its likely effect on industry.
- **Allocative efficiency** — where the financial system allocates financial resources to the most productive and valuable use. Central to achieving allocative efficiency is the ability of prices to adjust freely to give participants information about the value and risk of various financial products and services. Prices help allocate financial resources to productive uses. Prices also help allocate risks to those most willing and able to bear them, such as through insurance or derivative contracts. For prices to play this role, market participants require access to comprehensive information about the risks and expected returns of financial products. Allocative efficiency can be hampered by ineffective disclosure, government guarantees (explicit or implicit) and tax policies that distort price signals.
- **Dynamic efficiency** — where the financial system delivers price signals that induce the optimal balance between consumption and saving (deferred consumption). At times, policy intervention may be required to overcome behavioural biases that impede an economy's ability to allocate resources with dynamic efficiency. For example, Australia's compulsory superannuation system was introduced, in part, to overcome the tendency of individuals to underestimate the value of deferred consumption for long periods, such as for retirement.

Resilience

Resilience refers to the financial system's capacity to adjust to both the normal business cycle and a severe economic shock. A resilient system does not preclude failure, nor necessarily imply price stability. Rather, a resilient system can adjust to changing circumstances while continuing to provide core economic functions, even during severe but plausible shocks. In a resilient system, individual institutions in distress

should be resolvable with minimal costs to depositors, policy holders, taxpayers and the real economy.

Occasional episodes of financial instability are inherent in a market economy and are typically associated with asset price volatility, high levels of leverage, under-pricing of risks and mismatches between assets and liabilities. History suggests that events of instability will continue to occur, but their timing, severity and causes cannot be reliably predicted.

Although Australia's experience of the global financial crisis (GFC) was not as acute as that of other countries – in part because of a strong Commonwealth fiscal position, effective monetary policy, ongoing demand for commodity exports and a prudent and well-managed financial system – Australia has not always been so well placed. Land and property speculation in the 1880s and 1890s led to an economy-wide depression, with real per capita GDP falling 20 per cent and around half of the Australian trading banks closing.³ During the 1930s depression, a number of financial institutions faced depositor runs.⁴ In the late 1980s and early 1990s, an unsustainable boom, primarily in the commercial property sector, combined with poor lending practices and associated loan defaults, resulted in aggregate bank losses equivalent to one-third of shareholders' funds.⁵ This led to depositor runs on some institutions and was a contributing factor in Australia's recession at that time.

Severe financial shocks have broad negative consequences, both for individuals and for the general economy. Depositors, policy holders, creditors and shareholders of affected institutions can lose money. Credit and risk management services may be scaled back. In extreme circumstances, payments mechanisms may break down. Confidence in the financial system can evaporate, causing contagion to spread from distressed institutions to the rest of the system. General economic growth slows, unemployment rises and standards of living fall.

Australia's use of offshore funding, while beneficial to economic growth, makes the country vulnerable to sudden changes in international investor sentiment. Because of this, it is critical that the Australian financial system is resilient. As the cost of offshore borrowing is linked to the nation's credit rating, it is also critical that both federal and state governments maintain strong fiscal positions.

3 Maddock, R 2014, 'Capital markets' in Ville, S and Withers, G (eds), *The Cambridge economic history of Australia*, Cambridge University Press, page 274.

4 Fisher, C and Kent, C 1999, *Two depressions, one banking collapse*, Research discussion paper, 1999-06, Reserve Bank of Australia, Sydney, pages 13-14.

5 Gizycki, M and Lowe, P 2000, 'The Australian Financial System in the 1990s', paper presented at *The Australian Economy in the 1990s* conference held by the Reserve Bank of Australia, Sydney, 24-25 July, page 181.

Fair treatment

Fair treatment occurs where participants act with integrity, honesty, transparency and non-discrimination. A market economy operates more effectively where participants enter into transactions with confidence that they will be treated fairly.

Fair treatment does not involve shielding consumers from responsibility for their financial decisions, including for losses and gains from market movements. Some investor losses are an inevitable feature of a well-functioning market economy, which allows risk-taking in search of a return.

Behavioural biases and information imbalances⁶ can be detrimental to both financial system participants and system efficiency. Participants, including consumers, have a responsibility to accept the outcomes of their financial decisions, but financial firms should have regard to these information imbalances in treating their customers fairly.

Financial firms need to place a high degree of importance on treating customers fairly. This includes providing consumers with clear information about risks; competent, good-quality financial advice that takes account of their circumstances; and access to timely and low-cost alternative dispute resolution and an effective judicial system.

Roles and responsibilities of participants

Confidence and trust are essential ingredients in building an efficient, resilient and fair financial system that facilitates economic growth and meets the financial needs of Australians. However, confidence and trust cannot be prescribed in legislation. Rather, the Inquiry expects participants to fulfil the following roles and responsibilities in a way that engenders confidence and trust:

- **Consumers** are generally best placed to make financial decisions that meet their financial needs and have a responsibility to accept the outcomes of those decisions when they have been treated fairly.
- **Businesses**,⁷ both small and large, should be able to access funding and take productive risks to reap commercial rewards. The outcomes from these ventures should be shared according to well-defined and enforceable contractual terms. Businesses should not be prevented from failing, nor guaranteed access to private financial services on non market based terms.

⁶ In economic terms, ‘information asymmetries’. These occur when two parties entering into a transaction do not have the same level of information, placing one at an advantage over the other.

⁷ This includes financial firms.

- **Financial firms** (banks, insurers, financial advisers, superannuation trustees, responsible entities, lenders, brokers etc.) should act in the interests of their legal beneficiaries. Financial firms should earn the confidence and trust of customers by complying with their legal obligations and considering community expectations, thus limiting or avoiding the need for more prescriptive or interventionist regulation.
- **Regulators** are responsible for discharging their mandate and exercising their judgement to the standards of the civil service. To be effective, regulators should be independent and accountable, and have access to the appropriate regulatory tools and resources.
- **Governments** are responsible for setting policy that enables the financial system to facilitate sustainable growth and meet the financial needs of Australians, while minimising risk to taxpayers' funds. Governments have an obligation to act in the long-term national interest, rather than using the financial system for short-term political gain.⁸

Culture of financial firms

Since the GFC, a persistent theme of international political and regulatory discourse has been the breakdown in financial firms' behaviour in failing to balance risk and reward appropriately and in treating their customers unfairly. Without a culture supporting appropriate risk-taking and the fair treatment of consumers, financial firms will continue to fall short of community expectations. This may lead to ongoing political pressure for additional financial system regulation and the undermining of confidence and trust in the financial system.

An organisation's culture reflects its accumulated knowledge, beliefs and values in a way that sets norms for the behaviour of its employees and their decision making. Organisational objectives, business strategies and systems all influence employees' behaviour, which reflects on an organisation's culture. Leaders and their governing bodies determine organisational culture through their own conduct and design of objectives, strategies and systems. This creates competitive advantage.

The Inquiry considers that industry should raise awareness of the consequences of its culture and professional standards, recognising that, responsibility for culture in the financial system ultimately rests with individual firms and the industry as a whole. Culture is a set of beliefs and values that should not be prescribed in legislation. To expect regulators to create the 'right' culture within firms by using prescriptive rules is likely to lead to over-regulation, unnecessary compliance cost and a lessening of

8 For a discussion of the potential for financial system policy to be influenced by political interests, see, for example, Calomiris, C and Haber, S 2014, *Fragile by Design: Political Origins of Banking Crises and Scarce Credit*, Princeton University Press, Princeton.

competition. The responsibility for setting organisational culture rightly rests with its leadership.

The Inquiry's approach to financial system regulation

The starting point for the Inquiry's approach to examining the role of Government in the financial system is the Wallis Inquiry's philosophy of regulation.⁹ Insights provided by academic research and practical experience since then have advanced the Inquiry's understanding of the financial system. Critically, this new understanding has reduced the Inquiry's confidence in the inherent efficiency and stability of financial markets¹⁰ and increased its understanding of the financial system as a complex, adaptive network.¹¹ *Box 1: Implications of developments since the Wallis Inquiry* summarises the implications of some developments since the Wallis Inquiry.

Box 1: Implications of developments since the Wallis Inquiry

Developments since the Wallis Inquiry

The GFC has again demonstrated that financial systems are prone to **instability** and that the resulting financial failure can have a significant cost to taxpayers, economic output and employment.

The Australian financial system is part of a **global economy** increasingly influenced by Asia. It is affected by the increasing scope and complexity of cross-border financial regulation as well as other broader economic changes.

Lessons for this Inquiry

Australia remains susceptible to financial crises, including from the dislocation of international markets. A resilient system is required to bolster stability, prevent an increase in moral hazard and reduce risk to taxpayers.

Policy making should be coordinated, more accountable and better implemented to deal with changes in global regulation and in the financial systems of our major trading partners.

9 Commonwealth of Australia 1997, *Financial System Inquiry Final Report*, Canberra, Chapter 5 – Philosophy of Financial Regulation.

10 A recent survey of some of this research is provided by Brunnermeier, M, Eisenbach, T and Sannikov, Y 2013, 'Macroeconomics with Financial Frictions: A Survey', in Acemoglu, D, Arellano, M and Dekel, E (eds.) 2013, *Advances in Economics and Econometrics, Tenth World Congress of the Econometric Society, Volume II: Applied Economics*, Cambridge University Press, New York, pages 4–94. See also Allen, F, Babus, A, Carletti, E 2009, 'Financial Crises: Theory and Evidence', *Annual Review of Financial Economics*, volume 1, pages 97–116.

11 See, for example, Haldane, A 2009 *Rethinking the financial network*, speech to the Financial Student Association Amsterdam, 28 April.

Box 1: Implications of developments since the Wallis Inquiry (cont.)*Developments since the Wallis Inquiry*

Behavioural biases undermine the assumption that individuals are 'rational'. They limit the efficacy of disclosure as a regulatory tool and can lead to sub-optimal outcomes for consumers.¹²

Rapid **technological innovation** brings opportunities to improve user outcomes and system efficiency, but also raises new risks and challenges.

General acceptance that, in a severe financial crisis, **governments** (and taxpayers) may play a role in protecting the real economy.

Lessons for this Inquiry

Although disclosure remains a valuable tool to improve consumer outcomes, it should not be relied on in isolation.

Policy settings should facilitate innovation and accommodate market developments where these improve system efficiency and user outcomes.

To avoid moral hazard, regulatory settings should reduce the likelihood of Government support being required. However, Government should maintain a strong fiscal position with the capacity to provide this support in extreme circumstances.

The central role of market forces

Central to the Inquiry's philosophy is that the financial system should be subject, and responsive, to market forces, including competition. This is based on the Inquiry's view that the private sector is best placed to make decisions affecting the efficient allocation of resources.

Competition remains the cornerstone of a well-functioning financial system and is generally preferred to government intervention.¹³ Competition drives efficient outcomes for price, quality and innovation. However, the Inquiry recognises that competition alone does not always deliver the best balance between efficiency, resilience and fair treatment.

¹² See, for example, Kahneman, D 2011, *Thinking Fast and Slow*, Penguin Books Ltd, London.

¹³ Intervention is defined as including regulation, legislation, guidance, general supervision and enforcement.

Government prerequisites

Competitive markets need to operate within a strong and effective legal and policy framework provided by government. The characteristics required for the financial system to contribute effectively to sustainable economic growth are:

- Predictable rule of law with strong property rights, providing certainty of contract; protection from fraudulent, predatory and anti-competitive behaviour; and access to redress.
- Freely convertible floating currency and general free flow of trade, investment and capital across borders.
- Strong fiscal position.
- Sound monetary policy framework, including an independent central bank.
- Effective, accountable and transparent government.

Although these conditions are regarded as generally being met in Australia, Government should not underestimate their importance, and policy should be directed at their maintenance.

Sector-specific regulation in the financial system

The Inquiry believes the financial system requires sector-specific regulation, in addition to the above legal and policy prerequisites, for two reasons:

1. More so than other sectors, the financial system has the ability to create or amplify economic shocks because of its use of leverage, its complexity and its interconnectedness with the rest of the economy.
2. The significant harm to consumers that may result from complex financial decisions, or from dishonest and predatory practices, requires specialist regulation to promote fair treatment.

Sector-specific regulation is not unique to the financial system. Characteristics such as the high potential for harm and complexity result in specialist regulation in other industries, including aviation and pharmaceuticals. However, the Inquiry considers the potential effect on living standards or economic growth from mismanaging risk in the financial system requires more specialised regulatory oversight than that provided under general economy-wide trading rules.

Framework for policy intervention

The Inquiry's approach to policy intervention is guided by the public interest. Given the inevitable trade-offs involved, deciding how and when to intervene in the financial system requires considerable judgement by policy makers.

Intervention should seek to balance efficiency, resilience and fairness in a way that builds participants' confidence and trust. Intervention should only occur where its benefits to the economy as a whole outweigh its costs. Intervention should always seek to be proportionate and cost sensitive. However, in many cases, the assessment of costs and benefits will not be clear-cut and will require policy makers to exercise judgement – as has been the case for many matters considered by this Inquiry.¹⁴

Impediments to **efficient** market operations, such as information imbalances and principal agent conflicts, should be minimised.¹⁵ The Inquiry expects policy makers to set regulatory frameworks that encourage private sector competition and innovation by applying regulation on a functional basis, graduating regulatory obligations and assisting industry to overcome collective action problems.^{16,17}

A **resilient** financial system allows financial failure but manages it in a way that limits the cost to the general economy and taxpayers. The Inquiry believes policy makers should seek to minimise the chance of systemic crises, but have the right tools to manage such events when they do occur. As a last resort, Government should have the fiscal capacity to support the economy if required.

To encourage the **fair treatment** of participants in the financial system, policy makers should establish frameworks that ensure the orderly conduct of financial markets and minimise incidences of consumers buying financial products and services that do not meet their needs.

The Inquiry's philosophy places great responsibility on policy makers, particularly regulators, to make decisions that best balance the desired outcomes of efficiency, resilience and fair treatment. Principles-based decisions will often depend on regulators' professional judgement. Central to this approach is the need for appropriately skilled, effective regulators that are both independent and highly accountable for discharging their mandates.

14 Policy makers should use evidence-based approaches in policy analysis, including trials or pilots when feasible.

15 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 with resources and delegated responsibility to them for making decisions.

16 Functional regulation involves regulating similar economic functions in a similar way.

17 Graduated regulation involves providing lower-intensity regulation for businesses that pose lower risks to the system.

Box 2: General principles for policy makers

Determining when to intervene

- Intervention should be considered where it would improve the efficiency, resilience or fairness of the financial system, but only introduced if its benefit is judged to outweigh the costs to the economy as a whole.
- Unless there is a clear public interest, policy makers should give competitive markets the opportunity to adjust to market signals and allow established legal remedies to be enforced rather than pre-emptively regulating.

Delivering efficiency

- Policy makers should seek to remove distortions to the efficient allocation of funds and risks in the economy, and reduce unnecessary regulatory burdens.
- Policy makers should seek to encourage competition by removing unnecessary barriers to domestic and international competition.
- Policy settings should seek to encourage innovation by being technologically and competitively neutral in design.

Delivering resilience

- Private sector risk-taking should be supported, allowing both success and failure.
- Policy makers should seek to prevent a build-up of systemic risk. They should have systems in place to manage failing financial institutions in an orderly manner that protects the financial system's critical functions and maintains financial stability while minimising risk to taxpayers.

Delivering fair treatment

- Consumers should generally bear responsibility for their financial decisions, but should be able to expect financial products and services to perform in the way they are led to believe they will.
- Policy makers should be aware of, and design regulatory frameworks that take into account, behavioural biases.

Themes of this report

Australia's financial system has performed well since the Wallis Inquiry. Australia has a competitive financial system with sophisticated capital markets and firms that are quick to adopt new technologies that reduce costs or provide improved products and services.

Although Australia was not immune to the effects of the GFC, the financial system and institutional framework held up well compared with many financial systems elsewhere in the world. In particular, Australia's regulatory frameworks proved robust during this period.

However, the Inquiry's assessment is that Australia's financial system is at risk of falling short of its potential to operate in a manner characterised by efficiency, resilience and fair treatment. This assessment led the Inquiry to focus on the seven themes in this report (summarised in *Figure 1: Guide to the Financial System Inquiry Final Report*).

The first general theme, the **funding of the Australian economy**, refers to the core function of the financial system. A number of important opportunities for improvement in funding relate to tax. While taxation is outside the terms of reference of this Inquiry, a number of observations on tax are summarised in *Appendix 2: Tax summary*.

The second general theme, **competition**, underpins a well-functioning financial system and is integral to a number of recommendations of this report.

The Inquiry has also made recommendations within five specific themes, each of which is covered in an individual chapter:

- Strengthen the economy by making the financial system more resilient (*Chapter 1: Resilience*).
- Lift the value of the superannuation system and retirement incomes (*Chapter 2: Superannuation and retirement incomes*).
- Drive economic growth and productivity through settings that promote innovation (*Chapter 3: Innovation*).
- Enhance confidence and trust by creating an environment in which financial firms treat customers fairly (*Chapter 4: Consumer outcomes*).
- Enhance the independence and accountability of regulators and minimise the need for future regulatory intervention (*Chapter 5: Regulatory system*).

In addition, a number of other recommendations are summarised in *Appendix 1: Significant matters*.

Funding the Australian economy

The core function of the Australian financial system is to facilitate the funding of sustainable economic growth and enhance productivity in the Australian economy. This is the starting point for considering whether Australia's current financial system

Financial System Inquiry — Final report

is fit for purpose, which greatly influences the Inquiry's view on specific recommendations within this report.

As outlined in the Interim Report, it is difficult to assess and quantify the most efficient allocation of funding for the Australian economy.¹⁸ In the view of the Inquiry, the framework for the issuance and trading of debt and equity in Australia is operating reasonably well. Australia has a well-functioning equity market, a sophisticated wholesale financial market, and a privately owned banking and insurance system that provides a range of competitive retail products and services. However, some funding markets in Australia, including the corporate bond and venture capital markets, appear underdeveloped compared with those of some international peers.

The Inquiry has taken a principles-based approach to funding policy. The Inquiry believes government's role in funding markets should generally be neutral on the channel, direction, source and size of the flow of funds. Financial instruments, markets and forms of intermediation should develop, evolve and operate in ways that best reflect investor and borrower preferences and technological developments. Outside an extreme financial shock, there is generally little benefit in policy makers attempting to improve efficiency by insulating the economy from market forces. Instead, the Inquiry's approach has been to seek to identify and remove distortions to the inefficient allocation of resources.

The Inquiry has heard four main concerns in relation to the flow of funding in the Australian economy. First, that some funding markets, including the corporate bond and venture capital markets, are too small. Second, that particular sectors of the economy, such as small and medium-sized enterprises (SMEs) or rural businesses, do not have sufficient access to funding. Third, that the major banks may face a 'funding gap' that would restrict economic growth in the future. Finally, stakeholder input and Inquiry research indicate significant potential tax distortions.

Regarding the relative size of various funding markets, the Inquiry's approach is to seek to remove unnecessary regulatory settings that distort the flow of funds favouring the use of one market over another. In the case of the domestic corporate bond market, these include both tax and regulatory settings such as excessive disclosure requirements. The Inquiry does not believe mandating or subsidising a particular market in an attempt to increase its size (whether it be corporate bond, securitisation or venture capital markets) is an effective strategy in the long term. Instead, the size of a funding market should reflect market forces.

Some submissions also called on Government to influence the allocation of resources towards particular sectors of the economy perceived to have insufficient access to funding. For example, several submissions call on Government to encourage the

18 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, page 2-44.

investment of superannuation assets in infrastructure or to establish a Government-owned bank to direct funding to particular causes, such as rural businesses. The Inquiry does not support such approaches – to maximise the efficiency of the financial system policy makers should not set out to favour one particular funding destination over another.

The Inquiry has noted that SMEs have few options for external financing outside the banking system compared with large corporations. In part, this reflects unnecessary distortions, such as information imbalances and regulatory barriers to market-based funding. *Appendix 3: Small and medium sized enterprises (SMEs)* summarises the Inquiry's recommendations relating to SMEs.

As discussed in the Interim Report, some submissions also argued that the major banks face a 'funding gap'.¹⁹ These submissions suggest that in some circumstances banks would be unable to fund higher credit growth with new deposits, placing economic growth at risk. The Inquiry acknowledges that the ability of Australian banks to fund themselves is critical to their stability and is of great importance to the broader economy. However, on consideration of the relevant evidence and arguments, the Inquiry has concluded that Australia is not at risk from an emerging 'funding gap' for the following reasons:

- To the extent that some banks cannot source sufficient funding on commercially attractive terms to meet demand, market mechanisms such as the price of credit will attract alternative providers of funds, for example superannuation funds and other investors lending directly, greater prevalence of market-based financing or peer-to-peer lending.
- Such market mechanisms are also likely to increase the attractiveness of deposits as an investment vehicle under a high credit-growth scenario, thus increasing the supply of funding available to the banks (as occurred in Australia in the period following the GFC).²⁰

The Inquiry takes a neutral approach to the mechanism through which Australia sources its funding, including funding from offshore markets. The flow of funds should be subject to market forces and be free to evolve to meet user demands and market conditions.

The funding-related issue that concerns the Inquiry most is that of distortions to the market allocation of resources, including through taxation, information imbalances

19 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, page 2-78.

20 For a description of the interaction between the provision of credit and holding of deposits by banks, refer to McLeay M, Radia A and Thomas R, 2014 'Money creation in the modern economy' *Bank of England Quarterly Bulletin* Quarter 1, pages 14–27.

Financial System Inquiry — Final report

and unnecessary regulation.²¹ If unaddressed, such distortions are likely to lead to lower productivity and lower longer-term living standards than otherwise would be the case.

A significant number of the distortions identified are tax-related, as summarised in *Box 3: Major tax distortions*. Reducing the distortionary effects of these taxes should lead the system to allocate savings (including foreign savings) more efficiently and price risk more accurately. This would increase aggregate productivity and limit the build-up of systemic vulnerabilities.

Throughout this report, the Inquiry has made a number of recommendations relating to funding:

- The Tax White Paper should consider the reform of tax settings that distort the flow of funds (see *Box 3: Major tax distortions*).
- Obstacles to the growth of the corporate bond market should be addressed, including regulatory barriers and tax distortions, particularly the non-neutral treatment of savings vehicles (see *Appendix 2: Tax summary* and *Recommendation 33: Retail corporate bond market*).
- Reforms should be made to remove obstacles to SME financing, including facilitating crowdfunding and reducing information imbalances (see *Appendix 3: Small and medium sized enterprises (SMEs)*).
- To strengthen Australia's ability to continue to access funding, both domestically and from offshore sources, recommendations have been made to improve the resilience of the Australian financial system (see *Chapter 1: Resilience*).
- A more efficient superannuation system should result in more funds for investment as well as more effective investment decisions and more efficient allocations of funds (see *Chapter 2: Superannuation and retirement incomes*).

²¹ Refer to *Chapter 1: Resilience* for a discussion on distortions related to perceptions of implicit guarantees.

Box 3: Major tax distortions

A more neutral **tax treatment of savings vehicles** would reduce distortions in the composition of household balance sheets and the broader flow of funds in the economy. Across savings vehicles, after-tax returns differ markedly. For example, interest income is relatively heavily taxed.²² To the extent that distortions direct savings to less productive investments, a more neutral treatment would increase productivity.

For assets that generate **capital gains**, the tax treatment encourages leveraged investment, which is a potential source of financial system instability. Investors are attracted by the asymmetry in the tax treatment of expenses and capital gains, where individuals can deduct the full interest costs of borrowing (and other expenses) from taxable income, but only half of their long-term capital gains are taxed. The tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment in housing.

The implications of **dividend imputation** are less clear. The introduction of imputation reduced firms' cost of equity; however, the effectiveness of imputation in lowering the cost of capital arguably has declined as the economy has become more open. The tax benefits of imputation may encourage domestic investors to invest in domestic firms with domestically-focused investments, which would limit opportunities and increase risk from less diversified portfolios. To the extent that imputation distorts the allocation of funding, a lower company tax rate would be likely to reduce those distortions. A lower company tax rate would also enhance Australia's attractiveness as a place to invest, which would increase Australia's productivity and living standards.

Reducing the uncertainty and scope of taxes on **cross-border flows** would improve Australian entities' access to offshore savings. Access to offshore funding markets provides Australian entities with cheaper funds than otherwise would be the case. Having access to more diverse sources of funding reduces the risk from dislocation in one or more funding markets. That said, the complex, ad-hoc tax treatment of cross-border transactions reflects, in part, Government's desire to maintain the integrity of the tax base — from profit shifting and other tax avoidance strategies — in the face of continued financial innovation and internationalisation.

22 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-49.

Box 3: Major tax distortions (cont.)

For non-residents, repatriated income from Australian investments is subject to a regime of **withholding taxes**. The application and rate of withholding tax varies with respect to a host of factors, including the type of funding, the country of the foreign entity and the relationship between the domestic and foreign entity. Withholding tax increases the required rate of return for non-residents, which reduces the attractiveness of Australia as an investment destination. In cases where the non-resident can pass on the cost, the cost of funding is raised in Australia.

Refer to *Appendix 2: Tax summary* for additional information on the Inquiry's observations related to tax.

Competition

The Inquiry believes competition and competitive markets to be at the heart of its philosophy and sees them as the primary means of improving the system's efficiency.

This section builds on the discussion in the Interim Report of the competitive strength in various sectors of the Australian financial system.²³ It summarises the Inquiry's recommendations regarding amendments to current competitive regulatory settings and strengthening competition in the future. These recommendations are spread across a range of chapters in this report.

Competition in the financial system is generally adequate at present. The Inquiry's approach to encouraging competition is to remove impediments to its development. The Inquiry recommends making the following adjustments to current regulatory settings:

- Narrowing the differences in risk weights between authorised deposit-taking institutions (ADIs) using internal ratings-based models and those using standardised models in mortgage lending (see *Recommendation 2: Narrow mortgage risk weight differences*).
- Introducing a competitive process to allocate new default fund members to high-performing superannuation funds, unless the Stronger Super reforms prove effective (see *Recommendation 10: Improving efficiency during accumulation*).
- Refining the payments regulation framework (see *Recommendation 16: Clearer graduated payments regulation*).

²³ Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, Chapter 2.

- Supporting innovation and new entrants (see recommendations 14: *Collaboration to enable innovation*, 15: *Digital identity*, 18: *Crowdfunding*, 19: *Data access and use*, 20: *Comprehensive credit reporting*, 39: *Technology neutrality* and 30: *Strengthening the focus on competition in the financial system*).

In addition, the Inquiry notes that perceptions of implicit guarantees in the banking system can distort competition by providing a funding advantage to those banks believed to most benefit from such guarantees. Recommendations that increase the resilience of the banking sector, especially of the largest banks, will reduce these perceptions over time and help contribute to restoring a more competitive environment.²⁴

Notwithstanding the above recommendations to amend current regulatory settings, high concentration and trends towards increasing vertical integration in some sectors of the financial system have the potential to limit the benefits of competition in the future.

The Inquiry acknowledges that no single solution will guarantee the 'right' level of competition in the future – competition is a dynamic concept, changing over time. Instead, policy makers should be proactive in reviewing levels of competitiveness and removing barriers to the emergence of disruptive competitors, including both international entrants and domestic innovators.²⁵ In particular, the state of competition in the financial system should be reviewed every three years, including assessing changes in barriers to international competition (see *Recommendation 30: Strengthening the focus on competition in the financial system*).

Conduct and prudential regulators have a natural tendency to prioritise fairness or stability over competition and long-term efficiency. The long-term benefits of competition can be potentially difficult to identify or value, while the short-term costs of instability or unfair outcomes are immediately visible to regulators, governments and the general public. Therefore, the Inquiry has made a number of recommendations to ensure regulators are more sensitive to the effects their decisions have on competition:

- A Financial Regulator Assessment Board should be established to advise Government, including on how regulators consider competition issues in designing and implementing regulation (see *Recommendation 27: Regulator accountability*).

24 This approach has been recognised by the Financial Stability Board. See Financial Stability Board (FSB) 2014, *Adequacy of loss-absorbing capacity of global systemically important banks in resolution*, Basel, page 6.

25 The Inquiry supports the approach outlined in the draft report of the Competition Policy Review, suggesting a new Australian Council for Competition Policy be empowered to carry out market studies of competition in particular sectors. See Commonwealth of Australia 2014, *Competition Policy Review – Draft Report*, Canberra, Recommendation 39, page 57.

Financial System Inquiry — Final report

- An explicit requirement to consider competition should be included in the Australian Securities and Investments Commission's (ASIC) mandate (see *Recommendation 30: Strengthening the focus on competition in the financial system*).
- Regulators should more clearly explain in their annual reports how they have considered the effect of their decisions on competition and compliance costs (see *Recommendation 27: Regulator accountability*).

As discussed in the Interim Report, the Inquiry supports the implementation of the Council of Financial Regulators (CFR) recommendations on strengthening the financial market infrastructure (FMI) framework and Government's review of the market licensing framework.²⁶ This would create a framework under which competition and international financial integration in FMI could be increased.

As outlined in *Box 4: International competitiveness*, unnecessary barriers to international competitiveness and market access into Australia should be front of mind in designing and applying Australia's regulatory frameworks. The free flow of capital in and out of Australia significantly benefits competition and those who use Australia's financial system. For example, borrowers can lower their funding costs by directly accessing international bond markets, or they can borrow from Australian intermediaries that have lowered their funding costs by accessing less expensive foreign sources of capital.

Box 4: International competitiveness

Australia has relatively open financial markets: foreign financial services providers can generally provide retail services on the same terms as domestic competitors. Many wholesale markets are open to foreign providers, such as foreign ADI branches, without the need to comply with specific domestic regulatory frameworks – strengthening competition.

But Australia's financial sector is less open and internationally integrated than it could be now – and than it will need to be in the future.²⁷ More needs to be done to remove impediments to cross-border competition and other barriers to the free flow of capital across borders, such as tax impediments.

26 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-37.

27 For a discussion of international integration of the Australian financial system, refer to Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, Chapter 10.

Box 4: International competitiveness (cont.)

Developments and opportunities in Asia make change imperative. Financial system liberalisation and integration in our region creates an opportunity to mobilise surplus savings more efficiently and channel it to investment opportunities, supporting economic development and trade.

Where possible, policy makers should **avoid adopting unique Australian regulatory approaches** that are inconsistent with international practice. They should also remove impediments to recognising foreign frameworks for domestic purposes (either unilaterally or mutually). The Inquiry recommends:

- Government and regulators should identify rules and procedures that create **barriers to competition** and consider whether these can be modified or removed. (see *Recommendation 30: Strengthening the focus on competition in the financial system*).
- Government should also consider developing a mechanism to enable Australian fund managers to use **collective investment vehicles** that are more common overseas, such as a corporate vehicle (see *Recommendation 42: Managed investment scheme regulation*).

Government and regulators should develop and implement regulatory frameworks in ways that do not impose **unnecessary costs on Australian firms operating offshore** but support improved access to offshore markets.²⁸

Tax impediments to the free flow of capital add to the cost of doing business in Australia. They limit the capacity for Australia's financial system to exploit new and developing product areas, such as those for the Renminbi market, which would diversify financial solutions available in Australia.

Resilience

Australia weathered the GFC well relative to many international peers. However, it would be imprudent to assume the conditions that cushioned Australia during the crisis will exist when future shocks occur. Australia should heed the lessons learnt by other countries during the GFC. As a capital-importing country exposed to fluctuating terms of trade and characterised by a concentrated banking system, Australia needs to be better positioned than most.

28 A recent example is the financial services component of the China-Australia Free Trade Agreement, Department of Foreign Affairs and Trade 2014, *China-Australia Free Trade Agreement – Key Outcomes*, Canberra, viewed 19 November, <<http://www.dfat.gov.au/fta/chafta/fact-sheets/key-outcomes.html>>.

Australia will experience future financial crises. However, their timing and sources are difficult to predict. As outlined in *Box 5: Systemic and housing risk in Australia*, in some circumstances, the Australian financial system is vulnerable to a number of sources of risk that could severely damage both the economy and individuals' financial circumstances.

Box 5: Systemic and housing risk in Australia

A number of characteristics of the Australian economy and financial system present sources of potential systemic risk:²⁹

- As a large capital importer, Australia is susceptible to the **dislocation of international funding markets** or a sudden change in international sentiment towards Australia, which would reduce access to, and increase the cost of, foreign funding.
- As an open economy, Australia is exposed to **shocks** in the economies of our **major trading partners** and subject to volatility in commodity prices.
- Australia's banking system is highly **concentrated**, with the four major banks using broadly similar business models and having large offshore funding exposures.³⁰ This concentration exposes each individual bank to similar risks, such that all the major Australian banks may come under financial stress in similar economic and financial circumstances.
- Australia's banks are heavily exposed to developments in the **housing** market. Since 1997, banks have allocated a greater proportion of their loan books to mortgages, and households' mortgage indebtedness has risen.³¹ A sharp fall in dwelling prices would damage household balance sheets and weigh on consumption and broader economic growth. It would also reduce the quality of the banking sector's balance sheets and the capacity of banks to extend new credit, which would compromise the speed of a subsequent economic recovery.

A severe disruption via one of these channels would have broad economic and financial consequences for Australia. Indeed, interconnectedness within the financial system and the economy would be likely to propagate distress and heighten other risks and vulnerabilities.

29 A disruption to the financial system could be considered systemic if it was so widespread or severe that it caused material damage to the economy.

30 International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF, Washington, page 10.

31 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-56.

Given Australia's concentrated financial system, high household leverage and relatively high house prices, the Inquiry is particularly concerned about the banking system's exposure to housing. Despite housing risk being generally well understood by both regulators and the financial industry, the Inquiry has specifically considered this risk when making its recommendations.

More can be done to strengthen the resilience of Australia's financial system. Although no system can ever be 'bullet proof', Australia should aim to cultivate financial institutions with the strength not only to withstand plausible shocks but to continue to provide critical economic functions, such as credit and payment services, in the face of these shocks.

A number of aspects are critical to this strength, including an institution's capital levels, liquidity, asset quality, business model and governance, and Australia's sovereign credit rating. Of these, capital levels are particularly important, as they provide a safety buffer to absorb losses regardless of the source.

The Inquiry proposes a package of recommendations to enhance resilience in Australia's financial system. This package would make institutions less susceptible to shocks and the system less prone to crises. It would reduce the costs of crises when they do happen and improve the allocative efficiency of the system generally by reducing perceptions of an implicit guarantee. The package aims to minimise the cost to taxpayers, Government and the broader economy from risks in the financial system. In doing so, the package seeks to balance trade-offs between system safety and competitiveness where they are in conflict, and aspires to have competitively neutral regulatory settings where possible.

The Inquiry has primarily focused on reforms to two aspects of Australia's financial stability framework:

- ADI **capital levels** should be raised to ensure they are unquestionably strong. Evidence from banks, regulators and others suggests that Australian banks are not in the top quartile of large internationally active banks. Regulatory changes in other countries may further weaken the relative position of Australian banks. The Inquiry believes that top-quartile positioning is the right setting for Australian ADIs (see *Recommendation 1: Capital levels*).
- ADIs should maintain sufficient **loss absorbing and recapitalisation capacity** to allow effective resolution while mitigating the risk to taxpayer funds – in line with emerging international practice. Regulators' toolkits are critical and should be enhanced to prevent distress and to resolve failing financial institutions (see *Recommendation 3: Loss absorbing and recapitalisation capacity* and *Recommendation 5: Crisis management toolkit*).

In the Inquiry's view, raising capital requirements for ADIs would provide a net benefit to the economy. It would assist to avoid or reduce the severe and prolonged

Financial System Inquiry — Final report

costs of future crises, including high levels of unemployment. The cost of raising capital would be reduced by competition in the market, including the effect of the recommendations in this report. Drawing on multiple sources of evidence, the Inquiry calculates that raising capital ratios by one percentage point would, absent the benefits of competition, increase average loan interest rates by less than 10 basis points which could reduce GDP by 0.01-0.1 per cent.³²

Making the system more resilient also has efficiency benefits. Large or frequent financial crises create volatility and uncertainty that impede the efficient allocation of resources and harm dynamic efficiency by discouraging investment. In the resulting long periods of high unemployment, productive resources are under-utilised.

In addition, if implemented, this package of reforms should prevent the need for further structural reform in the industry, such as ring-fencing certain operations of the major banks. The Inquiry also believes that introducing the proposed reforms would reduce the need to pre-fund the Financial Claims Scheme (see *Recommendation 6: Financial Claims Scheme*).

Although stability settings aim to minimise the economic cost of financial institutions failing, it is not possible – or efficient – to eliminate failure altogether. Government must ensure its financial position remains sufficient to support the financial system in a future crisis. Macro-economic conditions can deteriorate rapidly in a crisis, and Government needs to remain alert to this. Maintaining a AAA credit rating would give Government the flexibility necessary to support the economy (although not necessarily the failed institutions) in such circumstances.

The GFC highlighted the benefits of Australia’s largely unleveraged superannuation sector. The absence of borrowing enabled the superannuation sector to have a stabilising influence on the financial system and the economy during the crisis. Restricting leverage in the sector will be important for mitigating future risks (see *Recommendation 8: Direct borrowing by superannuation funds*).

Superannuation and retirement incomes

Superannuation is now the second largest asset for many Australians. Its growing importance underlines the need for a regulatory approach that puts individual members at the very centre of the system – benefiting both individual Australians and the economy as a whole.

³² For details of this estimate, please see *Chapter 1: Resilience*. This is a conservative estimate that does not account for a number of important benefits, including reducing perceptions of an implicit guarantee, or factors that mitigate the cost, such as the effect of competition and monetary policy settings.

An efficient superannuation system is critical to help Australia meet the economic and fiscal challenges of an ageing population. While its importance for retirees and, to a lesser extent, taxpayers is self-evident, superannuation efficiency is also vital to sustaining long-term economic growth, given the system's increasing importance in funding Australia's prosperity.

Australia's superannuation system has considerable strengths. However, the system lacks efficiency in a number of areas.

The lack of clarity around the ultimate objective of superannuation policy contributes to ad hoc short-term policy making, which imposes unnecessary costs on superannuation funds and members, reduces long-term confidence in the system and impedes efficiency. The Inquiry believes the purpose of the superannuation system is to provide an individual with an income in retirement (see *Recommendation 9: Objectives of the superannuation system*).

At retirement, superannuation assets are not being efficiently converted into retirement incomes. This contributes to a significantly lower standard of living for some Australians in retirement and during their working life. Efficiency can be improved by removing barriers to product development and encouraging the take-up of pooled longevity products by requiring superannuation trustees to pre-select a comprehensive income product in retirement, while maintaining member choice (see *Recommendation 11: The retirement phase of superannuation*).

Economic growth will benefit if the growing number of retirees are able to sustain higher levels of consumption. The superannuation system is not operationally efficient due to a lack of strong price-based competition. As a result, the benefits of scale are not being fully realised. Although it is too early to assess the effectiveness of the Stronger Super reforms, the Inquiry has some reservations about whether MySuper will be effective in driving greater competition in the default superannuation market.

Unless the Stronger Super reforms prove effective, the Inquiry recommends introducing a competitive process to allocate new default fund members to high-performing superannuation funds. This would improve the competitive dynamics of the sector, reduce costs for funds and reduce compliance costs for employers (see *Recommendation 10: Improving efficiency during accumulation*).

Financial System Inquiry — Final report

The superannuation recommendations in this report have the potential to increase retirement incomes for an average male wage earner by around 25 to 40 per cent (excluding the Age Pension).³³ While these estimates are illustrative and based on models that cannot fully reflect the unique circumstances of different individuals, the Inquiry is confident that significant increases in retirement incomes can be achieved.

To protect the best interests of members the Inquiry has also made recommendations to improve the governance of superannuation funds (see *Recommendation 13: Governance of superannuation funds*) and remove restrictions on some employees choosing the fund that receives their Superannuation Guarantee contributions (see *Recommendation 12: Choice of fund*).

Innovation

For the financial system, technology-driven innovation is transformative. Opportunities for innovation are abundant as, fundamentally, the system revolves around recording, analysing and interpreting transactions, and managing associated information flows. With no physical products to manage, these processes readily lend themselves to improvements via digital technologies.

In Australia, the effect has been significant, particularly as Australian consumers are fast adopters of technology compared to consumers in many other countries.

The Inquiry cannot be certain of how future developments in technology will affect the financial system. Innovation is by its nature evolving and dynamic, and primarily driven by private sector commercial incentives and customer expectations. Instead, the Inquiry has focused on ensuring policy settings accommodate technological change to facilitate a dynamic, competitive, growth-oriented and forward-looking financial system.

³³ Estimates prepared by the Australian Government Actuary for the Inquiry, using input from Treasury models. Over 10 percentage points of the estimated increase in retirement income reflects the benefits of lower superannuation fees and savings from maintaining only a single superannuation account over a person's working life. The remaining portion (and range) reflects the use of a comprehensive income product in retirement; in particular, different combinations of an account-based pension and either a deferred life annuity or group self annuitisation product. The estimates are also sensitive to assumptions regarding the level of contributions, time in the workforce and the drawdown rate for the account-based pension. The major driver of the increase in retirement income is the benefit of pooling in retirement, which comes at a cost of smaller bequests from superannuation and reduced flexibility. For further details, see *Chapter 2: Superannuation and retirement incomes*.

The Inquiry has focused on reforms to Australia’s innovation architecture. It recommends:

- Government should review the costs and benefits of increasing access to, and improving the use of, data. As increasing amounts of data are collected and more sophisticated analytical techniques emerge, data can be used to develop alternative business models, products and services that improve user outcomes and system efficiency (see *Recommendation 19: Data access and use*).
- A national strategy for a federated-style model of trusted digital identities should be developed to set a framework and common standards to support the development of a competitive market in identity services that enhances consumer choice, privacy and security, and balances these objectives with financial system efficiency (see *Recommendation 15: Digital identity*).
- Government and regulators should remove unnecessary impediments to innovation by applying graduated functional frameworks in a range of areas, including the payments system. The Inquiry supports simplifying and clarifying payments regulation to facilitate innovation; lowering interchange fees to reduce costs for merchants and prices for customers; and preventing merchants from over-surcharging customers paying with debit and credit cards (see *Recommendation 16: Clearer graduated payments regulation* and *Recommendation 17: Interchange fees and customer surcharging*).
- Graduating the regulation of market-based financing will increase opportunities for small businesses to seek finance from the general public. The Inquiry supports facilitating crowdfunding and other innovative sources of finance (see *Recommendation 18: Crowdfunding*).

The Inquiry’s recommendations seek to provide more facilitative settings that enable financial firms to innovate – increasing competitive tension, delivering greater efficiency and enhancing user outcomes.

Consumer outcomes

To build confidence and trust, and avoid over-regulation, the financial system should be characterised by fair treatment.

In terms of fair treatment for consumers, the current framework is not sufficient. The GFC brought to light significant numbers of Australian consumers holding financial products that did not suit their needs and circumstances – in some cases resulting in severe financial loss. The most significant problems related to shortcomings in disclosure and financial advice, and over-reliance on financial literacy. The changes introduced under the Future of Financial Advice (FOFA) reforms are likely to address some of these shortcomings; however, many products are directly distributed, and issues of adviser competency remain.

Financial System Inquiry — Final report

Consumers should have the freedom to take financial risks and bear the consequences of these risks. However, the Inquiry is concerned that consumers are taking risks they might not have taken if they were well informed or better advised.

The Inquiry deliberated on a spectrum of approaches, from regulating core product features to introducing appropriateness and suitability tests for complex products, which are features of some international jurisdictions. The Inquiry has developed an approach that streamlines and complements the current framework and strengthens the accountability of product issuers and distributors. The Inquiry recommends the following package of reforms:

- The design and distribution of products should be strengthened through improved product issuer and distributor accountability, and the creation of a new product intervention power to allow ASIC to take a more proactive approach in reducing the risk of significant detriment to consumers (see *Recommendation 21: Strengthen product issuer and distributor accountability* and *Recommendation 22: Introduce product intervention power*).
- Standards of financial advice should be improved by lifting adviser competency (see *Recommendation 25: Raise the competency of advisers*), better aligning the interests of firms and consumers and enhancing banning powers (see *Recommendation 24: Align the interests of financial firms and consumers*).
- Regulatory impediments to industry use of technology should be removed (see *Recommendation 39: Technology neutrality*) and more innovative forms of disclosure developed (see *Recommendation 23: Facilitate innovative disclosure*).

The Inquiry expects these changes will reduce the likelihood of future losses similar to those experienced in recent financial investment collapses. Previous collapses involving poor advice, information imbalances and exploitation of consumer behavioural biases have affected more than 80,000 consumers, with losses totalling more than \$5 billion, or \$4 billion after compensation and liquidator recoveries.³⁴ The changes outlined in this report should also significantly improve consumer confidence and trust in the financial system.

The Inquiry considers that the additional regulatory elements of the package will rebuild consumer confidence and trust in the financial system in the long term, and should help to limit the need for more interventionist regulation in the future. For reputable firms with a strong customer focus, the Inquiry expects that costs involved in changing practices in response to the recommendations will be low. The Inquiry notes

³⁴ This estimate includes losses involving Storm Financial, Opes Prime, Westpoint, Great Southern, Timbercorp and Banksia Securities.

that success will require a greater level of regulator judgement, necessitating high-quality, accountable regulators with adequate funding.

The Inquiry also supports continuing industry and government efforts to increase financial inclusion and financial literacy to improve customer outcomes.

Regulatory system

The roles and performance of financial system regulators have an important effect on system efficiency. Strong, independent and accountable regulators assist in maintaining confidence and trust in the financial system.

The Inquiry considers that Australia's current regulatory architecture does not need major change. Although minor refinements are necessary, the roles of the three major financial regulators – the Reserve Bank of Australia, the Australian Prudential Regulation Authority (APRA) and ASIC – remain appropriate.

The Inquiry's philosophy places a high level of trust in regulators to make judgements that balance the efficient, stable and fair operation of the financial system. While acknowledging that regulators often have a difficult task, there is room for improvement. In particular, the current arrangements lack a systematic mechanism for Government to assess regulators' performance relative to their mandate. Instead, scrutiny tends to be episodic and focused on particular issues or decisions. A new Financial Regulator Assessment Board should be established to conduct annual performance reviews of regulators and provide advice to Government (see *Recommendation 27: Regulator accountability*).

Regulators also need to have the funding, expertise and regulatory tools to deliver on their mandates effectively. APRA and ASIC would benefit from more funding certainty, more operational flexibility and a greater ability to compete with industry for staff (see *Recommendation 28: Execution of mandate*). ASIC should be able to recover the costs of its regulatory functions from industry, and its powers need strengthening in some areas (*Recommendation 29: Strengthening Australian Securities and Investments Commission's funding and powers*).

Regulators should also undertake periodic, forward-looking capability reviews to ensure they are fit for purpose and have the capability to address future regulatory challenges.

Levels of financial regulation

Internationally, the pace of change in financial system regulation has surged since the GFC, with some of these regulatory changes yet to be fully agreed and implemented. As a capital-importing country, Australia has had little choice but to introduce many of these changes. This is on top of a range of fundamental changes in the domestic regulatory framework in the last decade, such as the Stronger Super, FOFA and national consumer credit reforms.

Financial System Inquiry — Final report

The Inquiry commissioned Ernst & Young (EY) to assess the cost effectiveness of certain regulatory changes implemented in the last decade.³⁵ Although the assessment highlighted broad agreement with the policy that led to the intervention, it also highlighted shortcomings in how policy makers and regulators approach regulatory design and implementation. These included gaps in consultation processes and optimistic time frames for implementation.

The Inquiry is very conscious that unnecessary and inappropriate regulation has the potential to reduce the financial system's efficiency. It therefore supports ongoing Government efforts to review and remove unnecessary regulation in the financial system and has not sought to duplicate this process.³⁶ The Inquiry makes recommendations to remove unnecessary regulation or improve regulatory processes (see *Recommendation 31: Compliance costs and policy processes* and *Recommendation 39: Technology neutrality*).

That said, the Inquiry recognises that many of its recommendations involve new regulation or changes to existing regulation. The Inquiry considers that these recommendations will both strengthen the financial system now and prevent excessive regulatory responses in the longer term. A more competitive and innovative financial system with minimal distortions will improve allocative efficiency and drive sustainable growth. A more resilient financial system will manage future financial shocks at a lower cost to the taxpayer and the real economy. A fairer financial system will avoid the need for more interventionist regulation in the future. In particular, the Inquiry is seeking to avoid rushed regulatory reactions motivated primarily by the political environment.

Of course, this Inquiry cannot guarantee that there will not be further unnecessary or poorly designed regulation in the future. The quality of new regulation will depend on the actions of industry, regulators and governments.

Conclusion

The Inquiry believes that, if implemented and enforced, the recommendations in this report should provide a robust framework to strengthen the financial system, and position it to meet Australia's evolving needs and support sustainable economic growth.

³⁵ Refer to *Chapter 5: Regulatory system* for further information on this research.

³⁶ The Commonwealth's whole-of-Government deregulation agenda is outlined in Department of the Prime Minister and Cabinet 2014, *Whole of Government deregulation agenda*, Commonwealth of Australia, viewed 14 November 2014, <https://www.dpmmc.gov.au/deregulation/whole_govt_agenda.cfm>.

The Inquiry recognises it has not addressed all issues put before it by interested parties. The Final Report, by necessity, prioritises those issues the Inquiry considers most important in setting a blueprint for the Australian financial system.

The issues examined and recommendations made by the Inquiry involve matters of judgement. Importantly, the Inquiry's test in these judgements has been one of public interest: the interests of individuals, businesses, the economy, taxpayers and Government. Some recommendations are likely to have a private cost for stakeholders. These costs have been explicitly taken into account in the Inquiry's deliberations. After carefully considering the evidence provided, the Inquiry's judgment is that the benefit to the public interest from these recommendations outweighs their associated costs.

The net result of these recommendations would be to:

- Encourage an efficient financial system to allocate Australia's scarce financial and other resources for the greatest possible benefit to the economy, promoting higher and more sustainable productivity and economic growth.
- Promote competition in the financial system, both now and into the future.
- Strengthen the resilience of the financial system, improving its capacity to adjust to both the normal business cycle as well as a severe economic shock.
- Lift the value of Australia's superannuation system and retirement incomes both for individuals and the economy.
- Drive economic growth and productivity by establishing policy settings that promote an innovative and dynamic financial system.
- Enhance the confidence and trust that users of financial products and services have in the financial system by creating a regulatory environment in which financial firms treat their customers fairly.
- Provide financial regulators with the right tools to achieve their mandates, while ensuring they are held accountable.

Such outcomes will improve efficiency, resilience and fair treatment in the Australian financial system, allowing it to achieve its potential in supporting economic growth and enhancing standards of living for current and future generations.

Chapter 1: Resilience

Australia's financial sector is not invulnerable to risks to stability, and the costs of crises can be wide-ranging and severe. Financial crises can deeply damage an economy and have a lasting impact on people's lives. Although Australia was not as acutely affected by the global financial crisis (GFC) as some countries, international experience suggests the average financial crisis could see 900,000 additional Australians out of work as well as substantially reduce the wealth of a generation.¹ Financial crises tend to be protracted, with unemployment remaining high for years. The average total cost of a crisis is around 63 per cent of annual gross domestic product (GDP), and the cost of a severe crisis is around 158 per cent of annual GDP (\$950 billion to \$2.4 trillion in 2013 terms).²

More can be done to strengthen Australia's economy and financial system by preventing and mitigating these costs. Although no system can ever be 'bulletproof', Australia should aim to cultivate financial institutions with the strength to not only withstand plausible shocks, but also to continue to provide critical economic functions, such as credit and payment services, in the face of these shocks. Australia also needs a system that minimises the costs to individuals, the economy and taxpayers when financial failure does occur. The world has learnt valuable lessons from the GFC, and Australia should look to benefit from this experience.

A more resilient financial system also has efficiency benefits. Large or frequent financial crises create volatility and uncertainty, which impede the efficient allocation of resources and harm dynamic efficiency by discouraging investment. In addition, the long periods of high unemployment following crises reflect under-utilised resources.

Government actions required to stabilise financial sectors both overseas and in Australia during the GFC reinforced perceptions that some institutions are implicitly guaranteed. The private sector accrued gains from financial activities in the run-up to the GFC, but losses and risk were shared with taxpayers when failures occurred or were threatened. These implicit guarantees create market distortions, altering the risk-reward equation and conferring a funding cost advantage on financial institutions perceived as guaranteed.

Removing perceptions of these guarantees will reduce Government's contingent liability and improve the efficiency of the financial system and economy. This chapter

1 Reinhart, C and Rogoff, K 2009, *This time is different: eight centuries of financial folly*, Princeton University Press, Princeton, page 224. The authors find that the average financial crisis increases unemployment by seven percentage points, which is almost 900,000 people as at October 2014.

2 Basel Committee on Banking Supervision 2010, *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, Bank for International Settlements, Basel, page 10.

recommends steps to minimise these perceptions in Australia. These steps will strengthen the resilience of banks and enhance resolution arrangements that minimise the need for taxpayer support. In the Inquiry's view, the alternative option of charging for such guarantees is not appropriate for Australia as it does not reduce the contingent liability of Government.

Strength in the financial system

The Australian financial system has characteristics that give rise to particular risks. The financial system is complex and highly interconnected with the rest of the world. Australia is a capital-importing nation with a significant component of domestic investment funded by foreign savings channelled through the banking system. The use of foreign investment, which the Inquiry expects to continue, has been advantageous for Australia, enabling higher investment and growth than would otherwise have been possible. Yet it also brings risks, such as vulnerability to a loss of foreign investor confidence, which may lead to increased costs and a sharp contraction in funds available for investment.

As the banking sector is at the core of the Australian financial system, its stability is of paramount importance. The sector is responsible for the majority of intermediation between savers and investors, and is highly interconnected with the rest of the financial system. In addition, the banking sector is concentrated, with the four major banks being the largest players in virtually all respects. This concentration, combined with the predominance of similar business models focused on housing lending, exacerbates the risk that a problem at one institution could cause issues for the sector and financial system as a whole. To prevent further concentration, the longstanding 'Four Pillars' policy, which precludes mergers between the four major banks, should be preserved as outlined in the Interim Report.

The importance of the banking sector means that it must be unquestionably strong to meet the needs of Australia. A number of aspects are critical to this strength, including an institution's capital levels, liquidity, asset quality, business model and governance, and Australia's sovereign credit rating. Australian authorised deposit-taking institutions (ADIs) are generally well placed in these respects, with strengthened capital and liquidity requirements, low loan losses, a business model focused on domestic and commercial banking, sound governance and a AAA-rated Government.

Of these, capital levels are particularly important, as they provide a safety buffer to absorb losses no matter what their source. In the Inquiry's view, although Australian ADIs are generally well capitalised, further strengthening would assist in ensuring capital levels are, and are seen to be, unquestionably strong. Liquidity is also very important and must be readily available. Given the considerable strengthening of regulatory liquidity requirements underway — the effects of which have yet to be seen — the Inquiry has not made recommendations in this area.

Australia's stability framework promotes strength in these aspects through:

1. **Active supervision by APRA** – a vital component that must remain strong. It is particularly useful for assessing the qualitative aspects of an institution's strength, including through the Australian Prudential Regulation Authority's (APRA) use of its Probability and Impact Rating System (PAIRS) risk assessment model.³
2. **Prudential requirements** – providing qualitative and quantitative measures, including ensuring adequate minimum capital and liquidity buffers for ADIs.
3. **Systems for dealing with financial institution distress** – where the strength of an institution proves to be insufficient, a robust framework for effectively resolving the failed institution is critical to minimise harm to the economy.

A robust stability framework provides a stable foundation for the financial system. Currently, financial system stability in Australia is underpinned by the continued strong financial performance of the banking system.⁴ Further, many of the reforms made to the Australian banking sector following the GFC have now settled. Strengthening necessary areas of the financial system at a measured pace now, rather than later, will cost less than actions to reinforce the system at a time when it is weak or where change must occur quickly. Reforms during good times also dampen pro-cyclicality in the financial system.

Determining the appropriate strength of stability settings is necessarily a matter of judgement. The Inquiry's test has been one of public interest: the interests of individuals, businesses, the economy, taxpayers and Government. The Inquiry believes that, on the basis of public interest, the benefits of the recommended measures outweigh the associated costs. The GFC demonstrated that risks are real and the cost of complacency is very high.

Recommended actions

The Inquiry's recommendations are designed to enhance the resilience of the Australian financial system, which underpins the strength and efficiency of the economy. The recommendations seek to make institutions less susceptible to shocks and the system less prone to crises, reducing the costs of crises when they do happen, and supporting trust and confidence in the system. They aim to minimise the use of taxpayer funds, protect the broader economy from risks in the financial sector and minimise perceptions of an implicit guarantee and the associated market distortions.

3 Australian Prudential Regulation Authority (APRA), *APRA Probability and Impact Rating System*, viewed 11 November 2014, <<http://www.apra.gov.au/AboutAPRA/Pages/PAIRS-1206-HTML.aspx>>.

4 Reserve Bank of Australia (RBA) 2014, *Financial Stability Review*, September 2014, RBA, Sydney, page 1.

Financial System Inquiry — Final report

The recommendations seek to strike a balance between system stability and competitiveness, and, where possible, aspire for competitively neutral regulatory settings. In many cases there is little trade-off, as greater stability promotes trust and confidence in the financial system and enhances resilience and long-term allocative and dynamic efficiency.

This chapter describes eight recommendations to strengthen stability settings, applying across a number of sectors.

Banking: these recommendations broadly have two objectives:

- **Reducing the probability of failure.** Evidence from ADIs, regulators and others suggests that Australian banks' capital ratios are not in the top quartile of internationally active banks when it comes to capital strength. The Inquiry believes it is in Australia's interest that they are. To this end, ADI capital levels should be raised. In achieving this, the transparency of existing capital settings and the competitive neutrality of the system for determining risk weights should also be improved. The risk-weighted approach to capital requirements should be supplemented with a leverage ratio that protects against potential weaknesses in the risk-weighting system.
- **Minimising the costs of failure.** The toolkits available to regulators to prevent distress and resolve failing financial institutions are critical and should be enhanced. ADIs should also maintain sufficient loss absorbing and recapitalisation capacity to allow effective resolution with minimal risk to taxpayer funds, in line with emerging international practice. As this area is complex and evolving, Australia should take a cautious approach in developing requirements for such capacity.

These recommendations, which reduce the probability of failure and minimise the cost of failure when it does occur, are complementary and should not be seen as substitutes for each other. Several of the recommendations focus on an ADI's liability structure: the mix of different types of debt and equity instruments used to fund the institution. *Box 6: ADI liability structures and prudential requirements* explains the main categories of instruments and the role these play.

Insurance: Significant reforms took place following the collapse of HIH Insurance Limited (HIH) in 2001, with ongoing subsequent improvements, including a comprehensive review of capital standards in recent years. The regulatory framework continues to change, with health insurers shortly moving to prudential supervision under APRA. Some of the proposals in *Recommendation 5: Crisis management toolkit* relate to insurance. Beyond these, the Inquiry has not seen a compelling case for further changing stability settings in insurance at this stage. However, as noted in *Chapter 4: Consumer outcomes*, Government is facilitating greater competition in the North Queensland market by clarifying restrictions on the use of Unauthorised

Financial Insurers (UFIs). Should the use of UFIs become widespread, the stability implications should be revisited.

Superannuation: The GFC highlighted the benefits of Australia's largely unleveraged superannuation sector. The absence of borrowing enabled the superannuation sector to have a stabilising influence on the financial system and the economy during the GFC. Continuing to restrict leverage in the sector will be important for mitigating future risks. The Inquiry recommends limiting borrowing in superannuation funds.

Financial market infrastructure (FMI): Substantial reforms have taken place since the GFC, such as making greater use of FMI for over-the-counter trading derivatives transactions. The Inquiry supports reforms to FMI regulation to strengthen the resolution framework and preserve critical functions in a crisis.

Shadow banking: Australia currently has a small shadow banking sector, which is reviewed annually by the Council of Financial Regulators (CFR). Although the Inquiry is making no direct recommendations to address shadow banking, it is aware that measures to enhance resilience in the banking sector could encourage some activities to move outside the prudential regulation perimeter. This risk is being actively monitored globally.⁵ In Australia, the CFR should continue to monitor risks in the shadow banking sector to enable prompt responses to notable changes.

More generally, the Inquiry notes that considerable work is continuing in the international arena to enhance financial system stability and that, where possible, Australia should align itself with international developments. Domestically, the CFR agencies continue to work on planning and pre-positioning to ensure they are ready to respond to any emerging threats to stability. The Inquiry is supportive of this work.

Finally, the Financial Claims Scheme (FCS) is a fundamental component in protecting depositors in the system, providing a guarantee on deposits of up to \$250,000 per account holder per institution. This is supported by Australia's system of depositor preference, which further protects depositors from loss. The Inquiry recommends maintaining the current ex post funding model for the FCS, while noting that the cap of \$250,000 is relatively high compared to other countries.

Principles

In making the recommendations in this chapter, the Inquiry has been guided by the following principles:

- Responsibility for sound governance, robust risk management and adequate financial soundness rests primarily with a financial institution's management and

⁵ Financial Stability Board (FSB) 2014, *Global shadow banking monitoring report 2014*, FSB, Basel.

Financial System Inquiry — Final report

its board. Financial institutions have a responsibility to operate with integrity to build and protect trust and confidence in the financial system.

- Instability in the financial system imposes large costs on individuals, the economy, Government and taxpayers. Minimising the risk of instability, or its impact where unavoidable, is a worthwhile investment. The wellbeing of the Australian community depends on the financial system being able to continue to provide its core economic functions, even in times of financial stress.
- Government should not generally guarantee the ongoing solvency and operations of individual financial institutions. However, there may be instances — particularly where system-wide failure is threatened — where public sector support of the basic functions of the financial system is warranted, such as liquidity support by the Reserve Bank of Australia (RBA). In determining whether to intervene in the event of a failure, Government should be guided by the anticipated effect of failure on the wider economy and seek to minimise taxpayer exposure.
- System stability should be promoted while giving due regard to the importance of balancing potential reductions in competition and efficiency. Where possible, regulation should be risk-based, as this helps ensure measures taken to establish stability are applied efficiently. Financial regulation should aim to be competitively neutral and not favour one type or class of institution over others, unless there is a sound public policy reason. An approach that combines strong regulatory and supervisory frameworks and market-based disciplines will deliver the best balance between financial stability and economic efficiency.
- In implementing regulation, Australia should build on global frameworks while reflecting features of the Australian system.
- The CFR has a shared responsibility for the stability of the financial system and monitoring systemic risks, while the member regulators retain ultimate responsibility and accountability for their respective mandates.

Conclusion

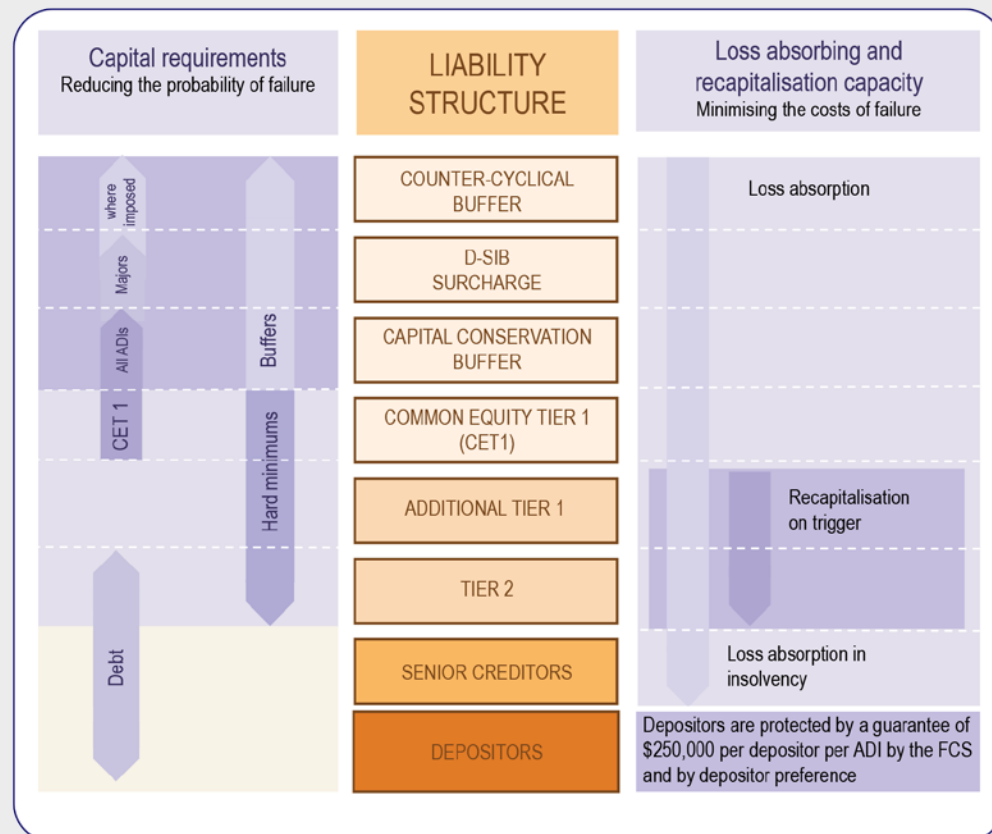
The Inquiry believes that implementing these recommendations, and continuing to develop policy based on these principles, will assist in ensuring Australia's financial system remains strong and stable into the future and continues to provide its core economic functions — even in times of financial stress.

The recommendations increase the system's resilience to institutional failure and, in doing so, reduce the likelihood of future crises. They aim to protect taxpayers and the Government balance sheet, help maintain investor confidence and increase efficiency in the economy. Where crises are unavoidable, the recommendations are designed to lessen their impact, minimising the need for taxpayer funds to be put at risk to support the financial sector and reducing the cost of a future crisis to the broader economy.

Box 6: ADI liability structures and prudential requirements

This box outlines the main components of an ADI’s liability structure. It describes the relationship of this structure with capital requirements, and loss absorbing and recapitalisation capacity.

Figure 3: ADI liability structure and prudential requirements



RWA: risk-weighted assets.
 D-SIB: domestic systemically important bank.
 CET1: common equity tier 1.

The liability structure is the mix of debt and equity instruments that the ADI uses to fund its activities, shown in the centre of Figure 3. Each category in the liability structure represents a layer in the creditor hierarchy. The top layer will be the first to absorb a loss. Once a layer has been depleted, further losses are applied to the next layer and so on. This means that the liability categories closest to the top of the structure are also the riskiest for investors and attract correspondingly higher rates of return. The corollary is that these instruments are also the most expensive sources of funding for the ADI.

Box 6: ADI liability structures and prudential requirements (cont.)

Historically, prudential requirements have been placed on the top layers of ADIs' liability structures to **reduce the probability of failure** — shown on the left-hand side of Figure 3. This includes capital requirements that mandate a minimum portion of the ADI's funding be in the form of certain regulatory capital. This chapter includes recommendations to strengthen these requirements, which include:

- **Buffers:** It's generally expected that an ADI's capital level will be above the level specified by the buffers, but it can fall below this level if necessary. When it falls below, restrictions are placed on dividends and bonus payments.
- **Hard minimums:** ADI capital levels must be maintained above specified hard minimums. An ADI would likely be declared non-viable if capital dropped below these levels.

More recently, international standard-setting bodies have worked on separate requirements to **minimise the cost of failures**. Although no such requirements are currently in place in Australia, the right-hand side of Figure 3 shows the capacity for different instruments in the liability structure to perform this function. This chapter includes a recommendation to introduce a framework for loss absorbing and recapitalisation capacity. This aims to ensure that, where an ADI fails, its liability structure enhances the ability to feasibly impose losses on creditors and recapitalise the institution, minimising the need for taxpayer-funded bail-out.

Measures to address the goals of reducing the probability of failure and minimising the cost of failure when it does occur are complementary, and meeting one objective should not be seen as a substitute for meeting the other.

This chapter makes extensive reference to the different types of regulatory capital included in the Basel framework:

- **Common Equity Tier 1 (CET1)** capital comprises 'tangible' equity such as shareholders' common equity. It is the primary defence against insolvency and bank failure.
- **Additional Tier 1 (AT1)** capital primarily refers to other forms of equity capital, such as preference shares, as well as some kinds of debt instruments with similar characteristics. Under the Basel framework, AT1 capital must be available to absorb the losses of a troubled institution before it becomes non-viable.
- **Tier 2** capital includes subordinated debt that has a 'bail-in' clause, meaning it can be converted to equity or written off should a set trigger condition be met.

Capital levels

Recommendation 1

Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.

Description

APRA should raise capital requirements for Australian ADIs to make ADI capital ratios unquestionably strong. A baseline target in the top quartile of internationally active banks is recommended. This principle should apply to all ADIs but is of particular importance for ADIs that pose systemic risks or access international funding markets.

The target would be aided by adopting *Recommendation 4: Transparent reporting*, which aims to improve the international comparability of Australian ADI capital ratios.

The Inquiry's judgement is that, although Australian ADIs are generally well capitalised, further strengthening the banking sector would deliver significant benefits to the economy at a small cost. Evidence available to the Inquiry suggests that the largest Australian banks are not currently in the top quartile of internationally active banks. Australian ADIs should therefore be required to have higher capital levels.

The quantum of any change should take account of the effect of other recommendations, particularly *Recommendation 2: Narrow mortgage risk weight differences*, which aims to improve competitive neutrality of regulatory settings.

Objectives

- Make banks less susceptible to extreme but plausible adverse events – such as asset price collapses – unexpected loan losses or offshore funding shocks, to reduce the likelihood of bank failures and promote trust and confidence in the banking sector.
- Create a financial system that is more resilient to shocks and thus less prone to crises, which can have devastating and long-lasting effects on the economy and society.
- Protect the Government balance sheet from risks in the financial system, to minimise the burden on taxpayers.
- Reduce perceptions of an implicit Government guarantee for ADIs and the associated economic inefficiency.

Discussion

Problems the recommendation seeks to address

Importance of capital in the banking sector

Capital, particularly equity capital, is an essential element in both actual and perceived financial soundness, acting as a shock absorber for unexpected losses. Once equity has been exhausted, a bank is generally non-viable — and could well have been before that point. Equity capital is therefore an important determinant of how likely a bank is to fail. Capital is also a safety buffer for creditors, as it is typically exhausted before the bank defaults on its obligations. By making creditor funds relatively safer, high levels of capital assist to maintain confidence in a bank, even in times of market stress.

Making banks safer and enhancing investor confidence both contribute to reducing the likelihood of a financial crisis. Shocks will always buffet the financial system, whether they are generated domestically or overseas. Capital is one of the best protections against those shocks generating a crisis.

Although banks choose capital at levels that account for their own specific risks, this does not account for the risks the banking system poses to the broader economy.

Risks and costs of financial crises

Australia's financial system is a vital part of the economy, providing avenues for saving, investment and funding growth. However, it also poses risks that must be managed. This includes minimising the likelihood of future financial crises, which can have significant costs for individuals, the economy, Government and taxpayers.

Australia should not underestimate the risks of financial crises

Australia's resilience during the GFC partly reflected the strength of the financial sector, the quality of its regulatory framework and supervision, and Government's assistance to the financial sector. However, many other important factors were also at play, including macro-economic policy, a strong Government balance sheet and Chinese resource demand. Given these supporting factors may not be present in the next crisis, Australia should not become complacent about the risks of financial crises as a result of its GFC experience. Australia is not immune to financial crises.

Australia can draw lessons from other countries' GFC experiences, which highlighted that financial systems are vulnerable to low-probability, high-impact 'tail events', which can be caused by large external shocks or be generated domestically. An asset value shock of similar magnitude to those experienced by overseas banks during the GFC would cause Australian banks significant distress.

For example, the major banks currently have a leverage ratio of around 4-4½ per cent based on the ratio of Tier 1 capital to exposures, including off-balance sheet. An overall asset value shock of this size, which was within the range of shocks experienced

overseas during the GFC, would be sufficient to render Australia's major banks insolvent in the absence of further capital raising. In reality, a bank is non-viable well before insolvency, so even a smaller shock could pose a significant threat. Following its recent stress-test of the industry, APRA concluded, "... there remains more to do to confidently deliver strength in adversity".⁶

Financial crises have large costs

The costs of financial crises are high, and their effects broad-ranging. Financial crises:

- Significantly constrain households' and businesses' access to credit, inhibiting the ability to invest, buy a home or grow a business.
- Potentially affect confidence in banks, which in turn may impact confidence in the operation of the payments system.
- Are historically associated with an average rise in unemployment of seven percentage points, which in 2014 would be almost 900,000 additional Australian workers.⁷ Recovery from financial crises can be protracted, with high unemployment continuing for a long period.
- Can result in large contractions in trade credit and make it more difficult for businesses, including small businesses, to access financing.
- Can substantially reduce the wealth and savings of a generation, particularly for those with lower initial wealth. This may particularly harm those people who rely most on savings, such as those in or close to retirement.
- Create large falls in GDP. International estimates of the GDP cost of a crisis are 19–158 per cent of one year's GDP – which for Australia would have equated to \$300 billion to \$2.4 trillion in 2013 – with a median of around 63 per cent of GDP (\$950 billion).⁸
- Erode a government's fiscal position. The need to directly support the financial system, along with the deteriorating budget position due to the associated recession, causes a substantial increase in net government debt. According to International Monetary Fund (IMF) data, general government net debt between 2007 and 2013 as a share of 2013 GDP rose by around 40 percentage points in the

6 Byres, W 2014, *Seeking strength in adversity: lessons from APRA's 2014 stress test on Australia's largest banks*, AB+F Randstad Leaders Lecture Series, 7 November, Sydney.

7 Reinhart, C and Rogoff, K 2009, *This time is different: eight centuries of financial folly*, Princeton University Press, Princeton, page 224.

8 Basel Committee on Banking Supervision 2010, *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, Bank for International Settlements, Basel, page 10.

Financial System Inquiry — Final report

United States, 50 percentage points in the United Kingdom, 55 percentage points in Portugal and more than 80 percentage points in Ireland.⁹

The Australian Federal Government is currently one of the strongest rated sovereigns in the world, with a AAA equivalent credit rating from all the major credit rating agencies. Significant deterioration in the fiscal position as a result of a financial crisis would be expected to threaten this rating. A reduction in Government's credit rating is likely to lead to the banks' credit ratings being downgraded, increasing funding costs.

As well as affecting the financial sector directly, a downgrade of the sovereign credit rating would raise Government's borrowing costs and damage Australia's reputation as a safe investment destination, ultimately harming the broader economy – including by raising borrowing costs for households and businesses.

Characteristics of Australia's banking system create additional systemic risks

Historically, Australia's growth has been assisted by the banks' role as a conduit for foreign savings to fund domestic investment – a trend the Inquiry expects to continue. However, the benefits of offshore funding come with the risk that foreign investors will stop lending to an Australian bank.

The Inquiry recognises that Australian banks have built a reputation for prudent risk management, with low levels of proprietary trading and sound management. However, maintaining foreign investor confidence in the strength of the Australian banking system is paramount for maintaining the banks' access to foreign funding. This goes beyond the strength of any individual bank, as Australia is a small part of the global financial system and investors may view Australian banks as a group. Many jurisdictions are still increasing capital levels to implement Basel III, a process largely complete in Australia. Over time, the relative strength of Australian ADI capital ratios may therefore decline as banks in other jurisdictions continue to increase capital.

Australia's highly concentrated banking sector, at the core of its financial system, poses a further risk. The majority of Australian banks pursue similar business models, with broadly similar balance sheet compositions that can be expected to have a high correlation during a crisis. The major banks form part of the largest Australian financial groups and are highly interconnected with the financial sector. Hence, disruption to the functioning of one major bank could be expected to impose significant costs on the economy, particularly if it resulted in contagion to other Australian financial institutions.

9 International Monetary Fund (IMF), *World Economic Outlook Database October 2014*, IMF, viewed 11 November 2014, <<http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/index.aspx>>.

Implicit guarantee

Actions taken by governments both in Australia and overseas to support their financial sectors during the GFC have reinforced perceptions of an implicit guarantee. Implicit guarantees arise when creditors believe that, if a bank were to fail, the government would step in to rescue the institution.

Implicit guarantees reduce banks' funding costs by moving risk from private investors onto the Government balance sheet – a contingent liability for Government. As a result, the creditor takes no (or a reduced) loss, making it less risky to invest in the institution. Creditors will therefore accept a lower interest rate, which lowers funding costs for the bank and provides a competitive advantage to those institutions most affected.

Empirical studies have found that Australian ADIs, especially the largest ADIs, benefit from an implicit guarantee.¹⁰ This is also evident in the credit ratings of the major Australian banks, which all receive a two-notch credit rating uplift from credit rating agencies Standard & Poor's and Moody's due to expectations of Government support. Implicit guarantees create inefficiencies by:

- Providing a funding cost advantage for banks over other corporations.
- Giving large banks an advantage over smaller banks.
- Weakening the market discipline provided by creditors.
- Potentially creating moral hazard that encourages inefficiently high risk taking.¹¹

Rationale

The Inquiry considers that these factors provide a compelling case for ensuring Australian ADIs have unquestionably strong capital ratios. The Inquiry's judgement, based on the available evidence, is that the CET1 capital ratio of Australia's major banks is currently not in the top quartile of internationally active banks, although it is likely to be above the median.¹² Although this position does not suggest capital levels at Australian ADIs are weak, it also does not suggest they are unquestionably strong.

Perceptions of an implicit guarantee introduce a range of damaging distortions into the financial sector that reduce efficiency. They also transfer risk from the banking sector

10 For example, International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF Country Report No. 12/308, IMF, Washington, DC.

11 International Monetary Fund (IMF) 2014, *Global Financial Stability Report April 2014*, IMF, Washington, DC; Independent Commission on Banking 2011, *Final Report*, Independent Commission on Banking, London, page 101.

12 On a broader measure of capital, which includes CET1, Additional Tier 1 and Tier 2 capital, Australian major banks are ranked lower reflecting their proportionally greater use of CET1.

Financial System Inquiry — Final report

to taxpayers. In the Inquiry's view, such factors make it appropriate to take steps to minimise implicit guarantees.

Raising capital requirements means that a larger share of bank funding would be in the form of equity — which is not perceived to have a guarantee — rather than debt. In addition, the perceived value of the guarantee for remaining debt would be lessened, as the ADI is safer and there is less chance the guarantee will be called upon. This reduces the implicit guarantee, in conjunction with *Recommendation 3: Loss absorbing and recapitalisation capacity* and *Recommendation 5: Crisis management toolkit*, which strengthen credible options to resolve an ADI with minimal recourse to public funds.

Options considered

1. **Recommended:** Set capital standards such that Australian ADI capital ratios are unquestionably strong.
2. Make no changes to capital ratio requirements.

Option costs and benefits

Summary of stakeholder submissions

Submissions from ADIs do not generally support increases to capital requirements — especially equity requirements — for a number of reasons.

They argue that increased capital, particularly equity, is unnecessary. As outlined in the Australian Bankers' Association's (ABA) second round submission (discussed later in this chapter), the Australian banks consider themselves to be highly capitalised relative to global peers. They argue that they are among the best capitalised banks in the world and are around or above the 75th percentile of capital ratios globally.¹³

The banks submit that their absolute (not only relative) capital position is very strong. Several banks note that internal stress tests show their capital position is sufficient to absorb large economic shocks, and APRA's stress-testing has not led the regulator to raise capital requirements.¹⁴

Despite the banks' submissions, the Inquiry notes that Standard & Poor's classifies the major bank capital ratios as 'adequate' but not 'strong' or 'very strong'.¹⁵

Several of the major banks point to the need to consider capital within the context of broader settings for financial stability in Australia. They argue that these broader

13 Australian Bankers' Association 2014, Second round submission to the Financial System Inquiry, page 36.

14 For example, Westpac 2014, Second round submission to the Financial System Inquiry, page 71.

15 Standard & Poor's 2014, *The Top 100 Rated Banks: Will 2014 Mark A Turning Point in Capital Cushioning?*, Standard & Poor's.

settings and conditions make Australia a safe environment, reducing or negating the need for additional equity.¹⁶ Such conditions include conservative prudential regulation, which is stricter in a number of aspects than in other countries, and intensive and effective supervision from APRA.

The banks also point out that equity is their most expensive source of funding and that this cost will be passed on (at least in part) to consumers, ultimately slowing credit and GDP growth. They note that other forms of regulatory capital, such as Tier 2 capital, would provide protection from losses at a lower cost. The banks did not provide estimates of the extent to which competitive pressure would limit any rise in loan interest rates, but they did note that the sector is highly competitive.

Some smaller ADIs suggest that it would be appropriate to impose an additional capital requirement on those banks APRA designates as domestic systemically important banks (D-SIBs), to offset funding advantages from perceptions of an implicit guarantee. They argue that offsetting the funding cost advantage of the implicit guarantee would improve competitive neutrality in the banking sector.¹⁷

APRA considers Australian banks to be well capitalised, but acknowledges that overseas jurisdictions are continuing to increase capital requirements for their domestic banks. APRA's preliminary view is that the major banks' CET1 ratios are likely positioned broadly in the middle of the second highest quartile of internationally active banks, which is consistent with the Inquiry's findings.

In its submission and subsequent discussions, APRA notes that stress-testing is a useful tool for assessing the riskiness of banks and their capital position. However, APRA cautions against relying on stress-testing too heavily to determine exact capital levels, given the margin for error in such exercises.¹⁸ It notes that many banks are still developing and improving their stress-test modelling as well as the critical data that underpins the models.

In addition, stress-testing exercises do not typically take into account more complex feedback loops and amplification mechanisms that can develop in practice. For example, banks are likely to respond to stress by cutting lending growth, which in turn may amplify stress and restrict economic recovery. Losses may also be more concentrated at one institution or a handful of institutions than can be assumed in the stress test. Even though a given institution may survive the *average* industry loss, it may be less resilient to a concentrated loss. As APRA notes in its most recent stress test, "... even though CET1 requirements were not breached, it is unlikely that

16 ANZ 2014, Second round submission to the Financial System Inquiry, page 4.

17 Customer Owned Banking Association 2014, Second round submission to the Financial System Inquiry, page 15.

18 Australian Prudential Regulation Authority 2014, Second round submission to the Financial System Inquiry, page 50.

Financial System Inquiry — Final report

Australia would have the fully-functioning banking system it would like in such an environment".¹⁹

A number of analysts, think tanks and academics argue that, although equity funding may be expensive for the banks, increasing it does not impose large costs on the economy overall in terms of higher loan interest rates or lower GDP growth.²⁰ They view greater use of equity funding as cheap insurance against the risks to which banking can expose depositors, Government, taxpayers and the broader economy.

Capital levels at the major banks

In the Inquiry's judgement, capital levels at Australia's major banks — as measured by CET1 capital — are likely to be above the global median but below the top quartile.

The Inquiry has not sought to determine the exact capital position of Australian banks on a consistent basis compared with banks in other countries. It is a very complex area, given the varied national discretions taken by different countries, including Australia. This is a task for APRA, taking into account the recommendations in this report. However, the Inquiry has sought to determine a plausible range for the current capital ratios of Australian banks for comparison with the current global distribution.

Based on the evidence available for the purposes of comparing with the global distribution, a plausible range for current Australian major bank CET1 capital ratios is 10.0–11.6 per cent (*Figure 4: Adjusted average Australian major bank CET1 capital ratios*). The lower bound is derived from the latest Basel Committee on Banking Supervision (BCBS) data, adjusted upwards by 0.8 percentage points to account for risk-weighted asset calculation differences based on APRA's RCAP (Regulatory Consistency Assessment Program) data.^{21,22} The upper bound derives from a report submitted by the ABA which calculates capital ratios based on the Basel minimum requirements.²³

19 Byres, W 2014, *Seeking strength in adversity: lessons from APRA's 2014 stress test on Australia's largest banks*, AB+F Randstad Leaders Lecture Series, 7 November, Sydney.

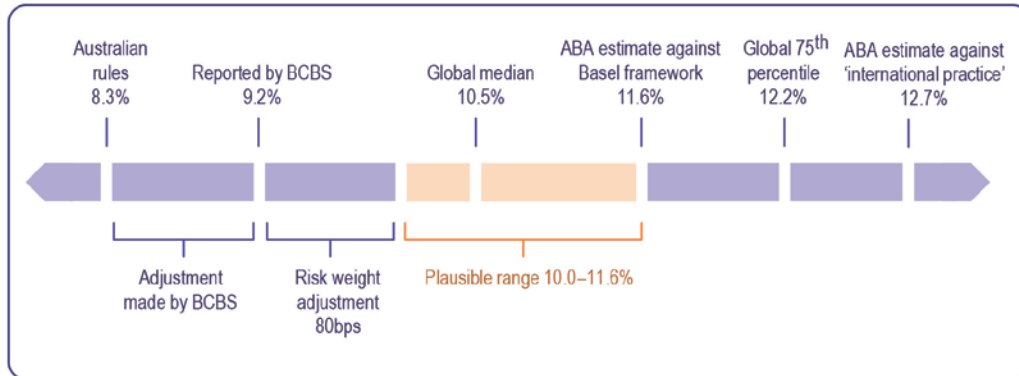
20 For example, Admati, A and Hellwig, M 2013, *The Bankers' New Clothes*, Princeton University Press, Princeton. At the extreme, some academics argue that changes in capital levels will not affect bank funding costs at all under certain conditions.

21 Australian major banks' position is contained in a non-public BCBS report and was provided to the Inquiry by APRA. The adjustment for risk-weighting calculation differences are in Australian Prudential Regulation Authority 2014, First round submission to the Financial system Inquiry, page 81.

22 Using the estimates from the ABA report, excluding those related to capital definitions (which the BCBS data adjusts for), the lower bound on the range would be 10.5 per cent.

23 Australian Bankers' Association (ABA) 2014, Second round submission to the Financial System Inquiry, *Appendix A: International comparability of capital ratios of Australia's major banks*. The ABA report was commissioned from PricewaterhouseCoopers. It uses bank data for March and June 2014, while the BCBS global distribution is as at December 2013. Between December 2013 and March/June 2014 the major banks increased CET1 capital ratios by an average of around 0.5 percentage points. A stricter comparison of the major banks to the global distribution could take this into account and suggest an upper bound of only 11.1 per cent.

Figure 4: Adjusted average Australian major bank CET1 capital ratios
Based on December 2013 global distribution



Sources: Australian Bankers' Association 2014, Second round submission to the Financial System Inquiry, *Appendix A: International comparability of capital ratios of Australia's major banks*; Australian Prudential Regulation Authority 2014, First round submission to the Financial System Inquiry, page 81; Basel Committee on Banking Supervision 2014, *Basel III monitoring report September 2014*, Bank for International Settlement, Basel; Inquiry calculations.

As Figure 4 shows, the available evidence suggests the major banks are not in the top quartile of CET1 capital ratios globally.

This view is supported by APRA's assessment that the largest Australian banks are broadly in the middle of the second-top quartile of their peers for CET1 capital ratios.²⁴

The Inquiry's conclusion updates the observation in the Interim Report that Australia's major banks were around the middle of the pack globally. That observation was based on data from the BCBS, which remains the most comprehensive data available for comparing capital levels across jurisdictions. However, although the BCBS data account for national differences in how capital is defined, they do not adjust for national differences in the way risk-weighted assets are calculated. Adjusting for this would move the Australian banks higher in the global distribution.

BCBS reported capital levels

Nonetheless, the BCBS provides the only available information about the distribution of global capital ratios, offering a useful context against which to compare Australian bank capital. The latest release, from December 2013, shows the CET1 capital global median and 75th percentile both increased to 10.5 per cent and 12.2 per cent respectively over the prior six months.²⁵ In that time, the adjusted Australian major bank CET1 capital ratios reported by the BCBS increased by a lesser amount, to 9.2 per cent on average. This highlights that many countries are still 'catching up' with

²⁴ Byres, W 2014, *Seeking strength in adversity: lessons from APRA's 2014 stress test on Australia's largest banks*, AB+F Randstad Leaders Lecture Series, 7 November, Sydney.

²⁵ Basel Committee on Banking Supervision 2014, *Basel III Monitoring Report, September 2014*, Bank for International Settlement, Basel.

Financial System Inquiry — Final report

their implementation of Basel III relative to Australia and, in a number of cases, are introducing stricter requirements than exist locally. It can be expected that the global distribution of capital levels will therefore continue to rise for some time yet.

ABA reported capital levels

The ABA submitted a report that endeavoured to adjust Australia's major bank capital ratios for differences between the Australian framework and estimates against the Basel framework and against international practice. Against the Basel framework, the ABA report assessed the average CET1 capital ratio across the major banks to be around 11.6 per cent as at August 2014. This approach considered similar items to those in APRA's submission, although the ABA's estimated value within categories was higher in a number of cases.²⁶ In the Inquiry's view, this estimate forms a plausible upper bound on the range of adjusted Australian major bank capital ratios.

Against its measure of international practice, the ABA report estimated a higher average CET1 capital ratio of 12.7 per cent. On this basis, it concluded that the major Australian banks were at or above the 75th percentile of identified international peers in terms of CET1 capital. Although this material was useful for considering the relative strength of Australian bank capital, its accuracy was limited by issues such as:

- The restricted number of comparison countries and banks — it used 52 banks, compared to 102 in the BCBS report.
- Minimal or no adjustment to foreign bank capital ratios to ensure they were on the same basis as the ABA-adjusted Australian bank capital ratios, which is crucial since the report directly compares these ratios.
- Attempting to adjust some items to 'international practice' where credible benchmarks are not available, rather than to the minimums set out in the Basel framework, where benchmarks are clearer.

There is no benchmark of international practice: all jurisdictions have implemented the Basel framework in a different manner, reflecting their domestic circumstances. As a result, it is highly complex to compare even two jurisdictions, let alone to compare all jurisdictions. This is reflected in *Recommendation 4: Transparent reporting*, which recommends using the Basel framework since a broader benchmark does not exist. In the Inquiry's view, the ABA's adjustments that go beyond comparisons to minimums in the Basel framework are not a plausible basis for international comparison.

Benefits of higher capital

Higher capital provides insurance against the large losses that can be caused by financial crises through reducing the likelihood of such crises. It achieves this by

²⁶ APRA's approach is outlined in APRA 2014, First round submission to the Financial System Inquiry, page 81.

making individual financial institutions safer and by promoting greater investor confidence in the system. It also reduces distortions caused by perceptions of an implicit Government guarantee. The benefits of increasing capital are not linear; however, the incremental benefit will decrease as the starting level of capital rises.

All financial crises are different, and the exact benefits of avoiding any particular crisis are therefore difficult to predict. Figures for the 'average' experience of a crisis should not be taken as precise estimates, but instead as indicative of the likely experience, noting that the actual magnitude can be much more severe.

Despite this limitation, a safer banking system that is less prone to crises provides large benefits, which accrue to individuals, the economy, Government and taxpayers.

Benefits to individuals

Financial crises are costly to individuals, both through the direct effects of financial institution failure and falls in asset prices, and as a result of the large recessions that typically accompany such crises.

Research on the 'average' financial crisis finds that the unemployment rate typically rises by around seven percentage points – over three times the increase in Australia during the GFC.²⁷ The associated economic weakness lasts around four years on average, meaning that high unemployment can be protracted. The effect is often greatest for younger generations, particularly those trying to enter the workforce for the first time.

Financial crises can substantially reduce the savings of an entire generation. In relative terms, the largest effect tends to be concentrated on those people with lower initial levels of wealth. This can have a lasting effect on society, particularly on those who are in retirement, or about to retire, and who have limited capacity to rebuild lost savings.

Benefits to the economy

In its review of 21 empirical studies, the BCBS found the median estimate of the cost of a crisis in terms of cumulative foregone output due to the economic downturn is 63 per cent of one year's GDP.²⁸ The estimate range is 19–158 per cent of one year's GDP, with the BCBS noting that the maximum cost of a crisis tends to be three to five times the average cost. Haldane estimated that the cost of the GFC, a particularly severe crisis, could be at least 90 per cent of 2009 world GDP.²⁹ More recently, the

27 Reinhart, C and Rogoff, K 2009, *This time is different: eight centuries of financial folly*, Princeton University Press, Princeton.

28 Basel Committee on Banking Supervision 2010, *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, Bank for International Settlements, Basel, page 10.

29 Haldane, A 2010, *The \$100 billion dollar question*, speech at the Institute of Regulation & Risk North Asia, 30 March, Hong Kong, Table 1, page 16.

Financial System Inquiry — Final report

Dallas Federal Reserve estimated the cost of the GFC to the United States economy at US\$6–US\$14 trillion (40–90 per cent of annual GDP).³⁰

The BCBS also estimates that financial crises occur, on average, every 20–25 years in a given country, implying a 4–5 per cent chance of a financial crisis in any given year. However, across the world, crises occur *somewhere* with much greater frequency, and these crises typically have spill-over effects for other countries.

Combined with this estimated probability, the median cost of a financial crisis suggests an annual expected loss of around 2½–3 per cent of GDP. In dollar terms, based on 2013 nominal GDP, this translates to an expected cost to the Australian economy of \$40–\$50 billion per year. If this estimate was instead based on the top of the BCBS’s range for the cost of a crisis, this figure would rise to \$100–\$120 billion per year.

Given these large potential costs, even a small reduction in the probability or cost of a crisis would yield significant benefits.

The Inquiry notes that the estimated benefit of avoiding crises will tend to understate the true benefit to the Australian economy, since it does not account for:

- Reduced perceptions of implicit guarantees. Weaker perceptions of an implicit guarantee reduce Government’s contingent liability and create fewer distortions to competition and efficiency in the financial system and broader economy. In addition, because ADIs are safer, any remaining perceptions of guarantee would be reduced.
- An economy with fewer crises is less likely to be volatile, which has welfare benefits and promotes long-term trust and confidence to support investment in the economy. In contrast, volatility undermines long-term confidence and the ability of individuals, businesses and Government to plan for the future, impairing allocative and dynamic efficiency.

Benefits to Government and taxpayers

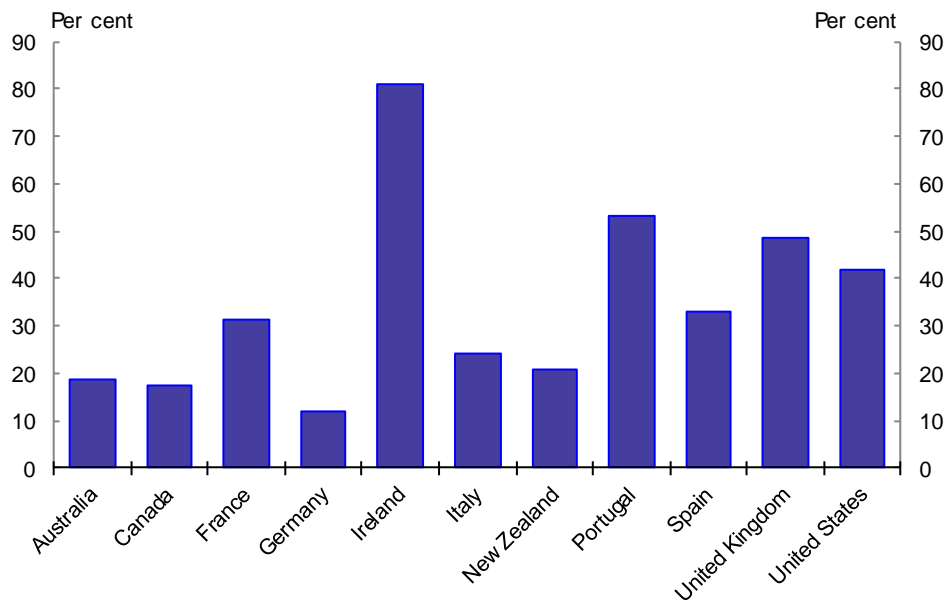
Reducing the likelihood of financial crises would protect Government and taxpayers from the costs of giving direct support to the financial sector. It would also help prevent the deterioration of the fiscal position due to the deep recession typically associated with financial crises.

The GFC clearly demonstrated the damage that can be done to governments’ fiscal position and the associated increase in net government debt. Chart 1 shows the change in general government net debt for a number of countries between 2007 and 2013, as a share of GDP. This captures the crisis period and the protracted recession that

³⁰ Atkinson, T, Luttrell, D and Rosenblum, H 2013, *How bad was it? The costs and consequences of the 2007–09 financial crisis*, Federal Reserve Bank of Dallas Staff Papers No. 20, Federal Reserve Bank of Dallas, Dallas, page 1.

followed in many economies. In parts of Europe, the recession and associated fiscal costs continue more than six years after the crisis began.

Chart 1: Change in general government net debt, 2007–2013
Per cent of 2013 GDP



Source: International Monetary Fund (IMF), *World Economic Outlook Database October 2014*, IMF, viewed 11 November 2014, <<http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/index.aspx>>.

The GFC and the associated economic downturn left the Australian federal and state governments with notably higher net debt, which has yet to peak, despite Australia's less acute experience of the GFC. The Inquiry understands there is limited room before Australia's AAA credit rating is threatened. Estimates suggest this would occur as Commonwealth and state debt levels approached around a 30 per cent net debt level.³¹

Another financial crisis like the GFC could put Australia's AAA credit rating in jeopardy, with likely knock-on effects for the credit ratings of Australian ADIs. This would make it more difficult for banks to access offshore funding markets, and would raise their funding costs.

Cost of higher capital

Overall, the expected cost of increasing capital requirements is small. The Inquiry estimates that a one percentage point increase in capital requirements would increase

³¹ Standard & Poor's 2014, *Ratings on Australia affirmed at 'AAA/A-1+' on monetary and fiscal flexibility; outlook remains stable*, media release, 29 July.

Financial System Inquiry — Final report

the average interest rate on a loan by less than 10 basis points.³² This is the figure if the full cost is passed on to consumers with no offset in interest rates by the RBA. However, in a competitive market, the actual change in lending interest rates would be lower and the RBA may lower the cash rate if conditions warrant. The Inquiry asked APRA to review its approach to generating these estimates, and APRA confirmed this approach was reasonable and consistent with other studies.

The Inquiry's estimated effect on loan interest rates is roughly in the middle of the range found in a number of studies. The surveyed studies find increases in loan prices for a one percentage point increase in capital ratio are 1–22 basis points.³³ The studies include:

- APRA's regulatory impact statement for the introduction of Basel III, which estimates a 5 basis points interest rate increase on a loan with a 50 per cent risk weight.³⁴
- A recent Bank for International Settlements (BIS) study on the impact of Basel III, which found a 12 basis points increase in loan prices per percentage point increase in capital, falling to around 8 basis points if only considering the advanced countries.³⁵

This low cost reflects that changing capital requirements only affect a small portion of the funding of a loan. For example, a one percentage point rise in capital requirements affects the funding cost of less than 0.5 per cent of the average loan.³⁶ That is, the funding cost on 99.5 per cent of the loan does not increase, and the incremental cost of equity over debt is only felt on the remaining 0.5 per cent.³⁷ Changing the cost of this small slice of a loan's funding therefore has a correspondingly small effect on the average funding cost.

RBA staff research suggests that an interest rate increase of this magnitude would reduce real GDP by less than 0.1 percentage points, while other studies suggest the

32 The precise quantum of additional capital necessary to place Australian ADIs in the top quartile of global peers is left to APRA to determine – the one percentage point increase here is for indicative purposes only.

33 See, for example, Barrell, R, Davis, E, Fic, T, Holland, D, Kirby, S and Liadze, I 2009, *Optimal regulation of bank capital and liquidity: how to calibrate new international standards*, Financial Services Authority Occasional Paper 38, London; Elliott, D 2009, *Quantifying the effects on lending of increasing capital requirements*, Center for Financial Stability; Kashyap, A, Hanson, S and Stein, J 2011, 'A macroprudential approach to financial regulation', *Journal of Economic Perspectives*, vol 25, no. 1; Miles, D, Yang, J, Marcheggiano, G 2011, *Optimal bank capital*, MPC Unit Discussion Paper No. 31., Bank of England, London.

34 Australian Prudential Regulation Authority (APRA) 2012, *Implementing Basel III capital reforms in Australia*, APRA, Sydney, page 15.

35 Cohen, B and Scatigna, M 2014, *Bank and capital requirements: channels of adjustment*, Bank for International Settlements, Basel, page 17.

36 The proportion of funding affected for a given loan is the change in capital requirement multiplied by the risk weight on that loan. The average risk weight of the major banks is currently less than 45 per cent.

37 Because higher capital makes the ADI safer, the funding cost of the 99.5 per cent of the loan may actually *decrease* to the extent that the risk premium demanded by debt and equity holders falls.

effect could be even lower.³⁸ In addition, the effect on growth would likely be taken into account in macro-economic policy settings since the RBA considers actual lending rates when determining the cash rate.³⁹

The Inquiry's estimate is consistent with a range of empirical studies that have estimated the effect of capital requirement changes on the economy (*Table 2: Effect on GDP of a one percentage point rise in capital ratio*). Studies examining the effect on GDP estimate that a one percentage point increase in capital ratios would potentially decrease annual GDP by 0.01–0.1 per cent (\$150 million to \$1.5 billion in terms of 2013 GDP) per year.

Table 2: Effect on GDP of a one percentage point rise in capital ratio*

Study	Effect on GDP**	Notes
Miles et al (2011)	1–5bps	Effect on level of GDP
BIS (2010)	3bps	Estimated lower growth during transition to higher capital. After implementation period, GDP recovers to trend.
BCBS (2010)	9bps	Effect on level of GDP
Barrell et al (2009)	10bps	Effect on level of GDP
Riksbank (2011)	6–16bps	For low and high social cost of capital respectively
*Capital ratio measured as equity to risk-weighted assets.		
**Note that definitions of capital vary across studies.		

Sources: Miles, D, Yang, J, Marcheggiano, G 2011, *Optimal bank capital*, MPC Unit Discussion Paper No. 31., Bank of England, London; Macroeconomic Assessment Group 2010, *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements*, Bank for International Settlement, Basel; Basel Committee on Banking Supervision (BCBS) 2010, *An assessment of the long-term economic impact of strong capital and liquidity requirements*, Bank for International Settlement, Basel, page 25; Barrell, R, Davis, E, Fic, T, Holland, D, Kirby, S and Liadze, I 2009, *Optimal regulation of bank capital and liquidity: how to calibrate new international standards*, Financial Services Authority Occasional Paper 38, London; Sveriges Riksbank 2011, *Appropriate capital ratio in major Swedish banks — an economic analysis*, Sveriges Riksbank, Stockholm, page 31.

Reducing perceptions of an implicit Government guarantee reduces Government's contingent liability. This benefit is not factored into the cost estimates above. The United Kingdom's Independent Commission on Banking report estimated that around half the cost of its proposal to increase capital was offset by a reduction in the implicit guarantee.⁴⁰

38 Lawson, J and Rees, D 2008, *A sectoral model of the Australian economy*, Reserve Bank of Australia Research Discussion Paper 2008-01, estimates that an unexpected 25 basis points increase in the cash rate reduces real GDP below its baseline by just more than 0.2 percentage points. A smaller estimate is provided in Jääskelä, J and Nimark, K 2008, *A medium-scale open economy model of Australia*, Reserve Bank of Australia Research Discussion Paper 2008-07 and Dungey, M and Pagan, A 2009, *Extending a SVAR Model of the Australian Economy*, Economic Record, vol. 85 no. 268.

39 For example, Battellino, R 2009, *Some comments on bank funding*, remarks to 22nd Australasian Finance and Banking Conference, 16 December, Sydney; Hansard 2009, *Reference: Reserve Bank of Australia annual report 2008*, House of Representatives Standing Committee on Economics, 20 February, Canberra.

40 Independent Commission on Banking 2011, *Final Report*, Independent Commission on Banking, London, page 141.

Box 7: The cost of raising capital requirements

To examine the potential effect on loan prices, this box provides a stylised example of a one percentage point increase in capital requirements. For simplicity, it does not account for a number of complications such as tax.

The effect on pricing is primarily driven by the proportion of funding that changes from debt to equity, the cost of the debt funding that is being replaced, and the cost of the new equity funding in terms of shareholder-required return on equity (ROE).

In Figure 5, a bank has a \$100 portfolio of loans (the asset), which is funded by a mixture of debt and equity (the liabilities).

Figure 5: Example of raising capital requirements

Assets		Liabilities	
Loans	\$100		Funding cost
		Debt	\$96 3.70%
		Equity	\$4 15%
		Weighted cost	4.15%

Before – 8% capital ratio, 50% risk weight

Assets		Liabilities	
Loans	\$100		Funding cost
		Debt	\$95.50 3.70%
		Equity	\$4.50 15%
		Weighted cost	4.21%

After – 9% capital ratio, 50% risk weight

Originally, the bank has a capital ratio of 8 per cent, with an average risk weight of 50 per cent. The bank therefore:

- Has \$50 in risk-weighted assets ($\$100 \times 50$ per cent risk weight).
- Uses \$4 of equity funding ($\50×8 per cent capital requirement) and \$96 of debt funding.
- Has a weighted average funding cost of 4.15 per cent given a cost of equity (target ROE) of 15 per cent, and an interest rate on debt funding of 3.7 per cent.

Box 7: The cost of raising capital requirements (cont.)

Increasing the capital ratio by one percentage point requires an additional \$0.50 of equity funding ($\100×1 percentage point capital increase \times 50 per cent risk weight). The additional cost is the cost of the new equity less the cost of the debt it replaces (15 per cent – 3.7 per cent) \times \$0.50, or \$0.06. To retain the same ROE, the bank charges an additional 6 basis points on the loan.

However, with greater equity, the bank would be safer so the risk premium built into both the cost of debt and investors' required ROE should fall. In addition, competition may limit the extent to which the bank decides to increase prices for customers. These factors would reduce the increase in loan price.

This is an indicative example that illustrates how capital increases affect pricing. Although the identified price increase should not be interpreted as a precise change that would occur, it gives the Inquiry confidence that the change in loan pricing due to a one percentage point rise in capital ratios would be less than 10 basis points.

Conclusion

The Inquiry's judgement is that, although Australian ADIs are generally well capitalised, strengthening the banking sector would deliver a net benefit to taxpayers and the broader economy. Evidence available to the Inquiry suggests the largest Australian banks are not currently in the top quartile of internationally active banks. Australian ADIs should therefore be required to have higher capital levels.

Unquestionably strong capital positions would deliver benefits by providing greater insurance against future financial crises and the associated harm to individuals, the economy, Government and taxpayers. Moreover, the cost of strong capital positions – the 'insurance premium' to reduce the risk of financial crises – is low. This cost would be reduced by competition in the market, including the effect of the recommendations in this report. The Inquiry estimates that a one percentage point increase in capital ratios would, absent the benefits of competition, increase lending interest rates by less than 10 basis points, which could reduce GDP by 0.01–0.1 per cent.

Although the benefits of higher capital are inherently difficult to quantify in a single number, to provide a net benefit to the economy, an additional percentage point of capital would only need to reduce the probability or severity of a crisis by 1 in 25 to 1 in 30.⁴¹

In addition, the RBA sets monetary policy, taking into account actual lending rates, and – to the extent that higher capital would affect GDP or inflation – can change the

41 As the expected average effect of a crisis is 2½–3 per cent of GDP per year, to justify a cost of capital of 0.1 per cent of GDP would require a reduction of 1 in 25 (0.1/2.5) to 1 in 30 (0.1/3) in the probability or severity of the crisis.

Financial System Inquiry — Final report

cash rate to at least partially offset the cost.⁴² Weighed against the risk of widespread unemployment, many households losing their savings, several years of economic recession and a large deterioration in the fiscal position, the Inquiry views this as a small cost.

The Inquiry recognises that the benefits of additional capital are likely to diminish the higher the starting level is. For example, moving from 2 per cent to 3 per cent capital is likely to have a larger effect on stability than going from 15 per cent to 16 per cent and, at some point, adding additional capital will not provide sufficient benefit to justify the added cost. However, in the Inquiry's judgement, capital levels at Australian ADIs are below this point and there are clear benefits to additional capital.

Implementation considerations

Determining the appropriate level of capital to ensure Australian ADI capital ratios are unquestionably strong necessarily involves judgement. In the Inquiry's view, if requirements are set such that ADI capital ratios are positioned in the top quartile of internationally active banks, this will achieve the goal of ensuring they are, and are perceived to be, unquestionably strong.

The optimal level of capital

A body of empirical work estimates the 'optimal' bank equity ratio for specific countries; that is, the level at which the net benefit to the economy is maximised. To the Inquiry's knowledge, such a study has not been undertaken for Australia. Studies from other countries typically find the optimal level of equity capital ratios is 10–20 per cent of risk-weighted assets.⁴³

Current minimum CET1 requirements for Australian banks, including CET1 buffers, are 8 per cent for D-SIBs and 7 per cent for others. Even after adjusting these to account for differences to the Basel framework — as outlined above — Australia's requirements are at the lower end of the range of international estimates of the capital ratio that maximises net benefits to the economy.

42 For example, Battellino, R 2009, *Some comments on bank funding*, remarks to 22nd Australasian Finance and Banking Conference, 16 December, Sydney; Hansard 2009, *Reference: Reserve Bank of Australia annual report 2008*, House of Representatives Standing Committee on Economics, 20 February, Canberra.

43 See Miles, D, Yang, J, Marcheggiano, G 2011, *Optimal bank capital*, MPC Unit Discussion Paper No. 31., , Bank of England, London; Basel Committee on Banking Supervision 2010, *An assessment of the long-term economic impact of strong capital and liquidity requirements*, Bank for International Settlements, Basel; Barrell, R, Davis, E, Fic, T, Holland, D, Kirby, S and Liadze, I 2009, *Optimal regulation of bank capital and liquidity: how to calibrate new international standards*, Financial Services Authority Occasional Paper 38, London; Sveriges Riksbank 2011, *Appropriate capital ratio in major Swedish banks – an economic analysis*, Sveriges Riksbank, Stockholm; Independent Commission on Banking 2011, *Final Report*, Independent Commission on Banking, London.

Of course, each system is different and there is no guarantee that what is appropriate for another country will be right for Australia. However, considering Australia's characteristics and circumstances, the ranges found in these studies support the idea that higher bank capital ratios would have a net benefit in Australia.

Further details

Unquestionably strong levels of capital would be beneficial for all ADIs. It may be argued that only the largest, most systemically important ADIs should be held to such a standard. However, in the Inquiry's view, the failure of an ADI would have adverse consequences for its customers and the economy, and has the potential to undermine confidence and trust in the system. As such, the Inquiry judges that this standard should apply to all ADIs. In addition, holding different parts of the banking system to substantially different standards would introduce an unwelcome distortion to the competitive neutrality of regulatory settings.

The Inquiry recommends that increases in capital ratios from current levels should primarily take the form of increases in CET1, as the highest quality form of capital providing the greatest level of protection against a bank failing. However, APRA should use its discretion regarding whether part of such change should be through Tier 1 capital or total capital requirements. Appropriate transition periods should be used to limit the costs of transitioning to higher capital.

In implementing this requirement, the interaction between this recommendation and the effects of *Recommendation 2: Narrow mortgage risk weight differences* should be taken into account. In addition, the Inquiry notes a higher capital base for all ADIs may reduce the need for future changes to the D-SIB buffer.

Narrow mortgage risk weight differences

Recommendation 2

Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.

Description

APRA should adjust the requirements for calculating risk weights for housing loans to narrow the difference between average IRB and standardised risk weights. This should be achieved in a manner that retains an incentive for banks to improve risk management capacity. It should also appropriately recognise the differences in the risks captured by IRB and standardised risk weights.

In making these changes, the adjusted framework should remain compliant with the Basel framework and remain risk sensitive.

Objectives

- Improve the competitive neutrality of capital regulation by limiting distortions caused by the differential regulatory treatment of different classes of ADI.
- Retain an incentive for ADIs to improve risk management capacity.

Discussion

Problem the recommendation seeks to address

Australia's current capital framework for ADIs includes two approaches to determining risk weights for the purpose of calculating capital ratios.

- **Standardised approach:** This is the default approach, where 'standardised ADIs' use a common set of risk weights that seek to reflect general risks of different broad asset classes. These risk weights are not tailored to a specific ADI and are set at a conservative level to ensure standardised ADIs are adequately capitalised.
- **IRB approach:** Accredited ADIs (IRB banks) use their own internal models to determine risk weights for credit exposures. These risk weights are tailored to the internally assessed risks of the asset and institution, and are more granular than standardised risk weights. Achieving IRB accreditation requires a strong and sophisticated risk management framework and capacity. To date, APRA has only accredited the four major banks and Macquarie Bank to use IRB models.

Prior to Basel II being introduced in 2008, all ADIs were required to operate with the same risk-weight model, which resulted in the same capital for a given asset, including loans. Since the IRB approach was introduced, the divergence in mortgage risk weights between the two approaches has widened, as IRB banks have refined their models and adjusted their balance sheets in light of modelled risks. The average mortgage risk weight for an ADI using the standardised model is currently 39 per cent – more than twice the size of the average mortgage risk weight for banks using IRB models, which is 18 per cent.⁴⁴

IRB risk weights are lower for many reasons, including because this method reflects a more refined calculation of the risks at IRB banks. However, the Inquiry notes that the principle of holding capital relative to risk should apply, not only within an institution, but also across institutions. In the Inquiry's view, the relative riskiness of mortgages between IRB and standardised banks does not justify one type of institution being required to hold twice as much capital for mortgages than another. This conclusion is supported by the findings of APRA's recent stress test, which found regulatory capital for housing was more sufficient for standardised banks than IRB banks.⁴⁵

The gap between average IRB and standardised mortgage risk weights means IRB banks can use a much smaller portion of equity funding for mortgages than standardised banks. Because equity is a more expensive funding source than debt, this translates into a funding cost advantage for IRB banks' mortgage businesses to the extent that the riskiness of mortgage portfolios is similar across banks.

Given that mortgages make up a significant portion of the assets of almost all Australian ADIs, competitive distortions in this area could have a large effect on their relative competitiveness. This may include inducing smaller ADIs to focus on higher-risk borrowers. Restricting the relative competitiveness of smaller ADIs will harm competition in the long run.

Rationale

The Inquiry considers that, absent other policy objectives, competitive neutrality is an important regulatory principle. In the case of risk weights, two policy objectives justify a difference in risk weights between IRB banks and standardised ADIs:

1. **To encourage improved risk management capacity at ADIs.** Achieving IRB accreditation can result in lower risk weights and a related reduction in funding costs. This is an incentive for banks to develop further risk management capacity to achieve accreditation.

44 Australian Prudential Regulation Authority 2014, Second round submission to the Financial System Inquiry, page 9.

45 "Regulatory capital for housing held by standardised banks was (just) sufficient to cover the losses incurred during the stress period; that was not the case for IRB banks", Byres, W 2014, *Seeking strength in adversity: lessons from APRA's 2014 stress test on Australia's largest banks*, AB+F Randstad Leaders Lecture Series, 7 November, Sydney.

2. **To conform with the principle that capital should be commensurate with risk.** This enhances efficiency and gives ADIs incentives to align risk and capital. Where an institution can model its risks to an acceptable standard, estimates from these models should reflect the actual risk of a portfolio and more accurately align risk and capital (the IRB approach). Where that capability does not exist, a benchmark risk weight provides a conservative measure to ensure the ADI is appropriately capitalised (the standardised approach).

The Inquiry accepts both policy objectives and believes they provide a reason for some difference in risk weights. It also notes a natural gap between risk weights under the two systems, reflecting that, unlike IRB risk weights, standardised risk weights take account of more than credit risk. However, in the Inquiry's view, none of these provide a sufficient rationale for the magnitude of the differences that have developed between IRB and standardised mortgage risk weights.

The Inquiry believes the incentive to improve risk management capacity can be maintained with a narrower difference between mortgage risk weights. In implementing this recommendation, APRA should preserve appropriate risk incentives and take into account differences in the broader frameworks for IRB and standardised ADIs.

This recommendation addresses appropriate competitive neutrality of the risk-weighting framework. Larger ADIs may have a number of other advantages, such as economies of scale, more sophisticated business models, and a greater ability to diversify assets and manage risk. These are part of the market process; the Inquiry is not suggesting these are a problem.

Options considered

The Inquiry considered two options to narrow the difference between standardised and IRB mortgage risk weights:

1. **Recommended:** Raise average IRB mortgage risk weights.
2. Lower standardised mortgage risk weights. In submissions, some ADIs argue that a mortgage risk weight of around 20 per cent would be appropriate.⁴⁶

Option costs and benefits

Raise average IRB mortgage risk weights

ADIs that use the standardised risk-weight model strongly support narrowing the difference between IRB and standardised mortgage risk weights. These ADIs argue

⁴⁶ For example, Suncorp Bank 2014, First round submission to the Financial System Inquiry, page 6.

they are at a considerable competitive disadvantage. In some cases, these ADIs contend that, without change, they will be forced out of the market – materially lessening competition. Although ADIs using the standardised model generally advocate for lowering standardised mortgage risk weights, many indicate that raising IRB risk weights would also address the problem.⁴⁷ This includes some smaller banks that have spent significant resources on IRB capacity but have not yet achieved IRB accreditation.

In general, the major banks advocate for smaller ADIs to be supported in achieving IRB accreditation, rather than making changes to risk weights. They are particularly opposed to raising IRB risk weights, arguing that changes to the IRB model could move the resulting risk weights away from the underlying principle that risk weights should reflect the actual risk of the portfolio. They also note differences in risk between mortgage portfolios at the major banks and some other ADIs. In discussions, some major banks indicated they had no strong objections to reducing standardised risk weights for mortgages.

One major bank submits that the effective difference between the credit risk portion of mortgage risk weights under the IRB and standardised models is small (in the order of seven percentage points), since reported standardised risk weights captured more than credit risk.⁴⁸ Although the Inquiry accepts the broader point that IRB and standardised risk weights capture different things, its judgement is that the gap is not likely to be as small as suggested by the bank's analysis. For example, that estimate adjusts for the D-SIB buffer, which is unrelated to risk weight models and not applied to all IRB banks. However, in implementing this recommendation, APRA should consider factors which generate a gap between standardised and IRB risk weights.

In discussions, one major bank argued that raising IRB risk weights would have effects beyond the mortgage market. In particular, it may induce them to reduce other types of lending, such as business lending, to offset overall increases in funding costs. While each institution will make its own lending decisions, many factors other than mortgage risk weights will affect the type of lending banks undertake, including the level of demand for overall credit, the strength of returns for the banks, the rate of capital generation and competition in the sector.

If this recommendation is adopted, APRA has indicated its strong preference is to narrow mortgage risk weights by raising IRB risk weights.⁴⁹ This reflects the need to maintain appropriate prudential capital settings, particularly for Australian ADIs'

47 Customer Owned Banking Association 2014, Second round submission to the Financial System Inquiry, page 27.

48 National Australia Bank 2014, Second round submission to the Financial System Inquiry, page 11.

49 Australian Prudential Regulation Authority 2014, Second round submission to the Financial System Inquiry, page 11.

largest exposure class, and that lowering standardised risk weights below 35 per cent would not be permitted under the Basel framework.

Stakeholders raised a number of concerns with the risk-weight approach to calculating capital ratios. The Basel Committee is already reviewing parts of the standardised and IRB framework. These measures include reducing the modelling choices in the IRB framework when determining estimates of credit, market and operational risk-weighted assets.⁵⁰ This work is not due to be completed until the end of 2015 but may result in increases in some areas.

This recommendation does not seek to eliminate entirely the difference in risk weights between the IRB and standardised models. It recognises that the current system provides incentives for ADIs to improve their risk management capabilities and that the IRB approach seeks to better align capital with risk.

Other countries have also placed restrictions on IRB mortgage risk weights through a number of means. For example, Sweden, Hong Kong and the United Kingdom have all used or proposed a mortgage risk-weight floor of 15–25 per cent. New Zealand has made a number of changes to the Basel-specified parameters for IRB models. Norway will introduce a 20 per cent floor on the loss given default parameter, which is the same as the current practice in Australia.

In addition to assisting with regulatory competitive neutrality, increasing IRB risk weights has two further benefits:

1. It would reduce the likelihood of the IRB approach underestimating risk, or being subject to model risk or outright manipulation.⁵¹ A minimum average risk weight prevents very low risk weights being assigned in a manner that may not reflect the true risk of an asset. The Inquiry notes that models based on individual borrower characteristics rarely capture the systemic risk that can become the primary risk driver at the portfolio level.
2. It would increase the capital IRB banks require, increasing their resilience.

The principal cost of raising the average IRB mortgage risk weights is that greater use of equity, which is typically more expensive than debt, would raise the average cost of funding for IRB banks. The cost of meeting higher average mortgage risk weights is expected to be small. The required quantum of capital to achieve an average risk weight of 25–30 per cent would be roughly equivalent to a one percentage point increase in major banks' CET1 capital ratios from current levels. This corresponds with a small funding cost increase for the major banks. Competition will limit the extent to

50 Basel Committee on Banking Supervision 2014, *Reducing excessive variability in banks' regulatory capital ratios: a report to the G20*, Bank for International Settlements, Basel.

51 Byres, W 2012, *Regulatory reforms – incentives matter (can we make bankers more like pilots?)*, remarks to the Bank of Portugal conference on Global Risk Management: Governance and Control, 24 October, Lisbon.

which this cost is passed on to consumers, and shareholders will likely bear some of the cost in the form of a lower ROE. This in turn should be at least partially offset by lower required returns due to the banks being less likely to fail.

Lowering standardised mortgage risk weights

The alternative option of lowering standardised mortgage risk weights to be closer to their IRB equivalents would have a similar primary benefit to the recommended option. It would promote competition and improve the future viability of smaller ADIs. In addition, as ADIs using standardised risk weights would need less equity funding, the costs identified above would run in the opposite direction, possibly giving those ADIs a funding cost reduction.

However, this option suffers from several drawbacks relative to raising IRB risk weights:

- It is non-compliant with the Basel framework.
- It would mean standardised ADIs use less equity and other regulatory capital funding, which could weaken their prudential position, making these ADIs less resilient and increasing their probability of failure.
- It would reduce the incentive to improve risk management practices and create an incentive for standardised ADIs to increase mortgage lending as a share of their balance sheet.

Conclusion

The costs to the economy of making the regulatory approach for mortgage risk weights more competitively neutral are modest. The Inquiry judges that these are outweighed by the long-term competition benefits of assisting to maintain a diversity of ADIs into the future.

The Inquiry judges the option of lowering standardised mortgage risk weights to be substantially inferior to the recommended option of raising IRB mortgage risk weights.

Implementation considerations

The recommended option is predicated on the existing Basel framework, which the Inquiry understands is currently under review. The intention is to narrow the difference between IRB banks and standardised average mortgage risk weights. If the existing Basel framework alters, this should be taken into account.

The Inquiry considers a range between 25 and 30 per cent to be appropriate, to be decided on by APRA in targeting an average IRB mortgage risk weight. This is based on international experience and the current average IRB and standardised mortgage risk weights of 18 per cent and 39 per cent respectively.

Financial System Inquiry — Final report

The risk weight gap could be narrowed in a variety of ways. In determining the approach, APRA should seek to maintain as much risk sensitivity in the capital framework as possible and recognise lenders mortgage insurance where appropriate.

This recommendation is focused on mortgage portfolios, given the importance of this market for Australian ADIs. APRA could also investigate whether similar issues exist in other portfolios.

The recommendation should be considered in conjunction with others in this report; in particular, *Recommendation 1: Capital levels* and *Recommendation 4: Transparent reporting* in relation to Australian ADIs' capital position and transparency of the capital framework.

To promote incentives for ADIs to develop IRB capacity, APRA could also consider how to make the accreditation process less resource intensive without compromising the (necessarily) very high standards that must be met. APRA has already indicated it is willing to explore a proposal to decouple the need to achieve internal model accreditation for both financial and non-financial risks simultaneously. That is, an ADI may be accredited for regulatory capital models for credit and market risks without having been accredited to model operational risk. The Inquiry supports exploring such initiatives.

Some ADIs will not use the IRB approach, because it may not be cost effective for smaller institutions. As such, the gap between IRB and standardised mortgage risk weights should be closed to improve competitive neutrality, regardless of any assistance provided to help with IRB accreditation.

Loss absorbing and recapitalisation capacity

Recommendation 3

Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.

Description

APRA should develop a loss absorbing and recapitalisation framework aligned with international standards: it should not generally seek to move outside international frameworks or ahead of global peers unless there are specific domestic circumstances to warrant this.

This framework should provide sufficient loss absorbing and recapitalisation capacity to facilitate the orderly resolution of ADIs. It should minimise negative effects on financial stability, ensure the continuity of critical functions and minimise the use of taxpayer funds.

Total loss absorbing and recapitalisation capacity should consist of an ADI's equity as well as debt instruments on which losses can credibly be imposed in a resolution. This includes debt instruments that can be converted to equity or written off where specified triggers are met to recapitalise the ADI or its critical functions.

The Inquiry supports pursuing such a framework, but cautions Australia to tread carefully in its development and implementation as this area is complex and evolving. The Inquiry recommends that the framework follow these guiding principles:

- Clearly set out the instruments eligible for inclusion in a loss absorbing and recapitalisation capacity requirement.
- Ensure clarity of the creditor hierarchy with clear layers of subordination between classes.
- Ensure clarity of the mechanisms and triggers under which creditors will absorb losses.
- Seek to ensure eligible instruments can be exposed to loss without adverse consequences for financial stability, including being held by investors who can credibly be exposed to loss.

The Inquiry intends that this framework would only include specific liabilities and not deposits. Deposits are protected by a guarantee under the FCS of up to \$250,000 per

Financial System Inquiry — Final report

account holder per ADI and by depositor preference. In Australia, deposits are not and should not be subject to bail-in.

In considering eligible instruments, the benefit of the lower cost of less subordinated instruments, such as a new layer between Tier 2 and senior unsecured debt in the creditor hierarchy, should be weighed against the ability to credibly write off or convert the instrument without causing financial instability. The clearer the mechanisms and triggers under which creditors will absorb losses are in advance, the more likely it is that this can be achieved. To this end, where losses are to be imposed through instruments being converted to equity or written off, issuing new contractual instruments has substantive advantages over broad statutory bail-in powers.

Objectives

- Ensure Australian ADIs have sufficient loss absorbing and recapitalisation capacity in resolution to make it feasible to implement an orderly resolution.
- Reduce perceptions that some banks are subject to an implicit Government guarantee to lessen market distortions created by this perception and improve competition in the banking sector.

Discussion

Problem the recommendation seeks to address

In a stable system, if financial institutions fail, they do so in an orderly fashion, without excessively disrupting the financial system, without interrupting the critical economic functions these institutions provide or exposing taxpayers to loss.⁵²

The Inquiry believes three aspects of Australia's framework for the orderly resolution of ADIs could be strengthened:

1. Effective crisis management powers for authorities. *Recommendation 5: Crisis management toolkit* addresses this aspect.
2. Effective pre-positioning and planning for the use of those powers. The Inquiry supports further work by authorities on this aspect.
3. Sufficient loss absorbing and recapitalisation capacity, which is addressed by this recommendation.

Currently, Australia does not have requirements for loss absorbing and recapitalisation capacity. Introducing a loss absorbing and recapitalisation capacity

⁵² Bank of England 2014, *The Bank of England's approach to resolution*, Bank of England, London, page 7.

framework creates credible alternatives to using taxpayer funds to resolve a bank and reduces perceptions of an implicit guarantee.

This is a focus of ongoing international policy work building on the experience of many national governments during the GFC, where significant taxpayer funds were put at risk to assist troubled banks as no other credible options were available to support financial stability. In many cases, even capital instrument investors were bailed out, despite these instruments being intended to absorb losses. As a core part of the G20 agenda to end the problems associated with some institutions being perceived as 'too-big-to-fail', the Financial Stability Board (FSB) is consulting on an international framework for loss absorbing and recapitalisation capacity for global systemically important banks (G-SIBs).⁵³ Indications are that many countries will also adopt these standards for D-SIBs. As a small, open, capital-importing economy, Australia cannot stand outside international practice.

An orderly resolution can be achieved with Government support, but this puts taxpayer funds at risk and protects bank creditors from loss. If Australia introduces a framework requiring banks to have sufficient loss absorbing and recapitalisation capacity, losses or recapitalisation costs are more likely to be borne by a failed bank's shareholders and creditors rather than taxpayers.

Further, if the market believes that Government support is the only viable option, this creates the perception of an implicit guarantee and the potential for associated distortions. The Australian Government support provided during the GFC, although not at the same level as in some other jurisdictions, has reinforced perceptions of an implicit guarantee for some banks in Australia.

Perceptions of implicit guarantees have costs, creating a contingent liability for the Government and distortions in the market. They reduce market discipline and potentially confer funding advantages on the banks involved. Credit rating agencies explicitly factor in rating upgrades for banks they perceive to benefit from Government support, directly benefiting these banks.⁵⁴ Reducing perceptions of implicit guarantees in Australia could therefore improve efficiency and competition in the banking sector.

Rationale

Australia's prudential framework is not, and should not be, premised on the assumption that ADIs will never fail, nor that unsecured bank creditors will never be exposed to loss. Inevitably, failures can and will occur, the system will be exposed to crises and, at times, unsecured bank creditors will be exposed to loss.

53 Financial Stability Board (FSB) 2014, *Adequacy of loss absorbing capacity of global systemically important banks in resolution*, FSB, Basel.

54 For example, see Standard & Poor's 2013, *Australia's developing crisis-management framework for banks could moderate the Government support factored into ratings*, Standard & Poor's.

Financial System Inquiry — Final report

A loss absorbing and recapitalisation capacity framework would help to implement an orderly resolution of a distressed ADI with minimum use of taxpayer funds. This would reduce perceptions of an implicit Government guarantee, thereby reducing the contingent liability of the Government and the associated market inefficiencies.

Options considered

The Inquiry considered two options:

1. **Recommended:** Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian ADIs and minimise taxpayer support.
2. Make no change to current arrangements.

Option costs and benefits

The banking sector disputes the need for additional loss absorbing and recapitalisation capacity. However, banks generally acknowledge that such a framework is inevitable given the work underway to develop a set of international standards.

In this context, most of the major banks argue strongly that senior unsecured debt should not be subject to bail-in. They contend that, were such a bail-in ever used, it could have a significant destabilising effect on the financial system. To this point, they note that senior unsecured debt is a vital funding source and that a loss of investor confidence in that market could be damaging. Instead, banks prefer a loss absorbing and recapitalisation capacity requirement in the form of existing Tier 1 or Tier 2 capital, or a new layer of loss absorbing debt distinct from regular senior unsecured debt.

The banks also warn that a loss absorbing and recapitalisation framework would introduce costs, as bail-in debt would have higher spreads than existing debt, reflecting the additional risk. This could be exacerbated if the demand for these bail-in instruments is limited and spreads increased further to encourage greater holdings. Banks submit that changes in funding costs would be passed on to consumers, at least in part, which would raise the cost of credit and potentially affect GDP growth.

APRA notes that the global debate is moving beyond how to reduce the probability of bank failure, which is addressed by capital requirements, and now focusing on how to reduce the cost of failure. This will result in a global loss absorbing and recapitalisation capacity framework for G-SIBs to remove perceptions that such institutions are too-big-to-fail. Although Australia has no G-SIBs, when seeking funding in wholesale markets, the internationally active Australian banks must compete against banks that meet these global requirements. These competitors include other internationally active banks from jurisdictions that adopt these standards more broadly.

The RBA acknowledges that the risks associated with a bail-in of creditors need to be carefully considered, but notes that this does not necessarily preclude its inclusion in the suite of available resolution tools. It advocates for taking a conservative approach to implementing such features in Australia.

A very large number of submissions are concerned that introducing bail-in provisions in Australia could lead to depositors' funds being bailed in to recapitalise a failed bank. The Inquiry strongly supports continuing the current Australian framework in which deposits are protected through an explicit guarantee under the FCS, supported by depositor preference. The Inquiry specifically does not recommend the bail-in of deposits.

The ultimate shape of the framework will influence the cost-benefit analysis. In assessing this, the most relevant factors are implicit guarantees, funding costs, lending rates, GDP and credit ratings.

Benefits

If banks have sufficient loss absorbing and recapitalisation capacity, a failed ADI is more likely to be resolved in a way that limits the effect of the failure on the broader economy, while minimising the use of taxpayer funds. This is a substantial benefit. As detailed in *Recommendation 1: Capital levels*, the costs of financial crises are wide ranging and severe. That recommendation focuses on reducing the probability of crises occurring in the first place, while this recommendation focuses on reducing the costs of crises that cannot be avoided. The magnitude of these avoided costs will depend on the specifics of the framework implemented. As an indicative measure, if the cost of financial crises is reduced by 10 per cent, it would provide an expected average benefit of 0.25–0.3 per cent of GDP per year (\$4–\$5 billion).⁵⁵

By making it more credible to achieve a resolution with minimal use of taxpayer funds, this recommendation also reduces perceptions of an implicit Government guarantee. There are clear benefits to the economy in minimising perceptions of implicit guarantees, including reducing Government's contingent liability and improving efficiency by removing market distortions, thereby making the banking sector more competitive.

Lending interest rates

Making it more credible and feasible for creditors to bear losses would raise the costs of the relevant types of debt funding for affected ADIs by reducing perceptions of an implicit guarantee.

Higher ADI funding costs could result in small increases in loan prices for customers. Banks have acknowledged in submissions that the cost of other forms of regulatory

⁵⁵ Based on the expected average cost of a financial crisis of 2½–3 per cent of GDP (\$40–\$50 billion) per year, as outlined in *Recommendation 1: Capital levels*.

Financial System Inquiry — Final report

capital would be less than the cost of increasing CET1 capital; the funding spread, and corresponding effect on lending interest rates, for subordinated debt is a fraction that of CET1 capital. Competitive pressure could see banks share some of the cost with investors through a lower ROE. Thus, the effect on loan interest rates is likely to be limited, even for a large increase in bail-in debt.

From an economy-wide view, reducing the implicit guarantee would offset at least part of the cost to banks by providing a corresponding benefit to taxpayers and Government, and reducing market inefficiencies. Greater volumes of new subordinated debt could also reduce the cost of existing subordinated debt on issue, since potential losses would be spread across a larger pool of claims. It should also reduce the cost of more senior debt, as losses become less likely to reach senior classes.

The Inquiry notes that markets for subordinated debt with conversion and write-off features are currently small and may require higher spreads to absorb large new issuance. This would particularly be the case if new requirements were implemented with short transitional arrangements.

GDP

The Inquiry expects the effect of higher lending rates on GDP to be minimal. An upper bound would be to assume that the full funding cost increase is passed through to loan interest rates, and that the RBA does not offset this through its setting of monetary policy. As discussed in *Recommendation 1: Capital levels*, the small expected effect on lending interest rates would lead to a correspondingly small effect on GDP.

However, a large part of the cost is offset by reductions in perceptions of an implicit guarantee. In addition, the RBA would likely consider the effect on GDP when formulating monetary policy.⁵⁶

Credit ratings

The net effect on credit ratings is unclear. Debt designed to more easily expose creditors to loss through write-off or conversion features is likely to be rated lower than debt without these features. However, it is not clear whether banks' credit ratings, which are based on the risk of loss to senior unsecured debt, would change as a result of introducing a loss absorbing and recapitalisation framework.

If the loss absorbing and recapitalisation framework increases ADIs' subordinated debt, there would be a larger buffer before senior unsecured debt takes losses. It may therefore make senior debt safer. However, introducing the framework may be taken as a signal of a lower likelihood of Government support for banks, especially since this is an intended outcome of the framework. Currently, the major banks receive a

⁵⁶ For example, Battellino, R 2009, *Some comments on bank funding*, remarks to the 22nd Australasian Finance and Banking Conference, 16 December, Sydney; Hansard 2009, *Reference: Reserve Bank of Australia annual report 2008*, House of Representatives Standing Committee on Economics, 20 February, Canberra.

two-notch credit rating upgrade on the basis of expected Government support.⁵⁷ Credit rating agencies may reconsider this upgrade in light of credible mechanisms to impose loss.

Conclusion

The Inquiry judges that there is a net benefit of a loss absorbing and recapitalisation capacity framework.

Loss absorbing and recapitalisation capacity on its own does not guarantee a successful resolution nor eliminate all perceptions of implicit guarantees. It must be part of a broader resolution framework that includes strong crisis management tools for regulators, as outlined in *Recommendation 5: Crisis management toolkit*.

The extent of the net benefit will be influenced by the ultimate shape of the framework, including the quantum, the composition and the time given for transition. Generally, costs will be higher the larger the capacity required, the more subordinated the eligible instruments and the shorter the period required to build the capacity. Benefits will be greater where loss absorbing and recapitalisation capacity is high and clear, and where creditor hierarchy and triggers are transparent. However, if designed carefully and according to the articulated principles, the framework can attain net benefits.

Implementation considerations

Sufficiency

To minimise the need for taxpayer support, ADIs need sufficient capacity to absorb losses and, in some cases, provide the recapitalisation necessary to implement their resolution strategy.

This may require enough capacity to fully recapitalise the institution. International work proposes that G-SIBs need a range of 16–20 per cent of risk-weighted assets and twice the Basel leverage requirement.⁵⁸ A similar quantum may be appropriate for internationally active Australian ADIs.

For smaller banks, an orderly resolution may be possible through activating the FCS or through a merger or acquisition at the point of resolution. In this case, the loss absorbing and recapitalisation capacity sufficient to implement the resolution plan is likely to be lower.

The Inquiry recommends considering a graduated approach across the banking sector when developing the loss absorbing and recapitalisation capacity framework for

57 Standard & Poor's 2013, *Australia's developing crisis-management framework for banks could moderate the Government support factored into ratings*, Standard & Poor's.

58 Financial Stability Board 2014, *Adequacy of loss absorbing capacity of global systemically important banks in resolution*, FSB, Basel, page 6.

Australia. This approach should take into account the likely resolution strategy for an ADI.

Eligible instruments

The framework should consider a broad range of equity and debt instruments.

Equity instruments have the advantage of being well understood by investors. These instruments have a long history of automatically absorbing loss without causing systemic disruption. However, they are more expensive than debt funding and may not be available in resolution, having already been depleted. Experiences overseas suggest that ADIs only tend to enter resolution after significant losses have been incurred and there is little or no equity value left.⁵⁹ That is, equity instruments may not be available to assist in recapitalising a distressed institution.

Requiring eligible debt instruments would give the regulator greater confidence that the loss absorbing and recapitalisation capacity will be available in resolution. These instruments are not depleted until a trigger has occurred, so – once triggered – they can act to replenish capital. This gives the regulator greater certainty about the resources that will be available when conducting their resolution planning. Debt instruments are also typically less expensive than equity instruments.

Additional Tier 1 and Tier 2 capital instruments with conversion and write-off features, which already exist in the Basel framework, can provide loss absorbing and recapitalisation capacity. Investors already hold these instruments. As these conversion features are relatively new, instances of instruments being converted into equity or written off are very limited. If constructed carefully, a new layer of contractual instrument in the creditor hierarchy between Tier 2 and unsecured senior debt would have similar benefits to Tier 2, at a lower cost. In substance, it should be no less credible than a Tier 2 instrument.

Addressing challenges

Stakeholder submissions, and a wide range of policy research and commentary, note a number of major difficulties in implementing a bail-in regime that can be credibly activated in a crisis.

Most concerning is the possibility that activating a bail-in for creditors of one bank may actually worsen the crisis. This could occur if converting one bank's creditors caused creditors of other banks to reassess the likelihood that they will take a loss, resulting in investors withdrawing funds (or refusing to roll over debt) to other banks in the system. This contagion could cause acute liquidity problems and distress in other banks, exacerbating the crisis. Also, if banks were unable to access international funding markets, it could take longer for them to resume lending to the economy once the crisis is over, potentially prolonging an economic downturn.

⁵⁹ Gracie, A 2014, *Making resolution work in Europe and beyond – the case for gone concern loss absorbing capacity*, speech given at the Bruegel breakfast panel event, 17 July, Brussels.

Addressing these challenges is critical to developing a viable loss absorbing and recapitalisation capacity framework. Although such difficulties give reasons to be cautious, in the Inquiry's view these can be addressed, especially given the considerable work underway on these issues globally. In developing its own framework, Australia should take account of this international work to create a system that, where possible, overcomes the problems associated with bail-in by being credible, predictable, in line with international practice, and having an appropriate transition period.

Other considerations

To keep any costs to a minimum, an appropriate implementation period should be allowed where the framework imposes a significant quantum.

Developing a successful loss absorbing recapitalisation framework depends on a large number of other important aspects, which this Final Report will not discuss in detail. These aspects include:

- Possible need for legislative change; for example, to ensure certainty of the creditor hierarchy.
- Considering whether requirements form part of Pillar 1 or Pillar 2 requirements.
- Ensuring the legal basis for exposing creditors to loss is sound and the framework adequately accounts for where an ADI is part of a group or operates across borders.

Transparent reporting

Recommendation 4

Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework.

Description

APRA should develop a common reporting template that, where feasible, identifies the effect of areas where Australia's capital framework for ADIs is different to the minimum requirements set out in the Basel framework.

Objective

- Reduce disadvantages that may arise for Australian ADIs due to difficulties in comparing Australian ADI capital ratios to international peers.

Discussion

Problem the recommendation seeks to address

No benchmark of international practice exists for calculating capital ratios. All countries use variations to the minimum Basel capital framework, making it challenging to determine a common international benchmark against which to compare Australian bank capital ratios. This inhibits the relative strength of Australian banks from being accurately assessed against banks from other jurisdictions.

This problem arises because, in some areas, the Basel framework allows for more than one approach, or provides that a requirement should be specified but leaves it to national discretion to determine the detail. In addition, many individual jurisdictions adopt stronger standards than the Basel minimums. As a result, no two jurisdictions take exactly the same approach to calculating capital ratios.

Like banks in all advanced countries, Australian bank capital requirements are based on the Basel framework but adjusted to meet domestic needs. This has resulted in aspects being more stringent in some areas, and less so in others, than the approaches taken in other jurisdictions. Thus, although Australian banks can be benchmarked against the Basel minimum, they cannot be benchmarked against other countries' practices.

Simply comparing Australian bank capital ratios to those reported by their international peers may therefore be misleading.

To make informed decisions and price debt appropriately, investors assess differences in banks' financial strength, including capital. Although it is generally possible to identify significant differences in jurisdictions' approaches to calculating capital ratios, estimating and comparing the effect of those differences is challenging. The banks have made substantial efforts to raise investors' awareness of aspects of Australia's requirements that are stronger than the minimums. However, investors are hesitant to trust banks' self-reported adjusted capital ratios.

Quantifying the cost of this lack of comparability is difficult. Australia's major banks have some of the highest credit ratings in the world, which may suggest that costs are limited.⁶⁰ Likewise Australian bank equity valuations are among the highest in the world. However, banks contend that the lack of transparency affects market pricing. They also suggest that market access may be compromised in times of market stress, when investors are particularly risk sensitive.

The Inquiry encountered significant difficulty in comparing Australian banks' capital ratios to those of international peers. As discussed in *Recommendation 1: Capital levels*, there are limited data available that try to compare capital across countries on a consistent basis, and every source that attempts this has drawbacks.

The Inquiry was presented with several estimates against different benchmarks, all of which were only able to provide a partial analysis and yielded results that varied markedly.⁶¹ This demonstrates both the value of developing a consistent approach and the difficulty of achieving it. Even where stakeholders provided estimates of how Australian bank capital ratios compared to the Basel minimum requirements – leaving aside the added difficulties of comparing directly to international banks – the results had notable differences.

The major banks submit that APRA could adequately address this issue by developing a standard template to quantify the areas where Australian bank capital ratios are more or less conservative than the minimum Basel requirements. They note that this work has begun but sought the Inquiry's support to progress it as a priority.

APRA submits that, in implementing the Basel framework to suit the Australian environment, its primary goal is ensuring capital adequacy for each ADI. However, APRA also sees value in comparing capital ratios appropriately, particularly for the largest banks operating internationally, and has no objection to ADIs reporting a capital ratio based on Basel minimum requirements. Nevertheless, it argues that the additional requirements imposed by each jurisdiction mean it is not practically possible to compute a comparison to the practices of other jurisdictions.

60 Many factors contribute to Australian banks' credit ratings in addition to their capital ratios, including the strong Australian Government credit rating and the sound macro-economic environment in Australia.

61 A number of submissions addressed this issue, including from APRA, the Australian Bankers' Association, the major banks and Mørgj Analytics.

Conclusion

Without action, investors may not be able to assess Australian banks' relative capital position. This can reduce access to funding and raise funding costs, particularly at times when investors are more sensitive to risk. Given the existence of a relatively low-cost option to address this situation, it is not desirable to maintain the status quo.

This recommendation would be most beneficial if other countries implemented similar reporting mechanisms. Recognising that national discretions can impair comparisons across jurisdictions, the Basel Committee on Banking Supervision has been working to address this issue, including by publishing survey data on how different countries use discretions.⁶² However, even in the absence of action by other countries, introducing such reporting in Australia is still of benefit. It would translate Australian ADI capital ratios into an easily understandable, known international benchmark, even if other countries have differences within their own jurisdictions.

The Inquiry has not sought to quantify the extent to which transparent reporting may affect funding costs or access to funding. However, it notes that the benefits are likely to be more pronounced in times of market stress. Most of the cost of implementing this option would fall to the major banks, which see a substantial net benefit in this change.

The Inquiry notes that APRA has begun developing reporting in conjunction with industry in line with the current recommendation. Given this reporting would be most beneficial to banks with investors that seek exposure across banks in multiple jurisdictions, APRA should consider whether reporting should be voluntary to avoid imposing costs on those banks for which it would serve no benefit.

An alternative option is to change the way capital ratios are calculated to be more consistent with the Basel minimum framework, in effect reducing APRA's use of national discretion. This may achieve a similar outcome with regard to international transparency. However, it would have a wider range of costs and take substantially longer to implement than the recommended option. As such, the Inquiry does not recommend this approach.

62 Basel Committee on Banking Supervision 2014, *Basel capital framework national discretions*, Bank for International Settlements, Basel.

Crisis management toolkit

Recommendation 5

Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry.

Description

In September 2012, the previous Government consulted on a comprehensive package, *Strengthening APRA's crisis management powers*.⁶³ The CFR has also recommended separate changes to resolution arrangements and powers for FMI.⁶⁴ In 2013, these processes were put on hold as part of a Government moratorium on significant new financial sector regulation pending the outcome of this Inquiry. Government should now resume these processes, with a view to ensuring regulators have comprehensive powers to manage crises and minimising negative spill-overs to the financial system, the broader economy and taxpayers.

The Inquiry strongly supports enhancing crisis management toolkits for regulators. It is important for the two processes to be concluded, giving due consideration to industry views on the packages.

Objectives

- Promote a resilient financial system.
- Enable the orderly resolution of distressed financial institutions.

Discussion

Problems the recommendation seeks to address

Given the importance of ADIs, insurers, superannuation funds and FMI to the functioning and stability of the financial system and economy, regulators need comprehensive powers to facilitate the orderly resolution of these institutions.

Responding to local and global changes, CFR agencies reviewed the existing legislative provisions for prudentially regulated institutions and FMI. These reviews paid close attention to international standards and developments, particularly G20 and FSB initiatives to promote resilient financial systems and frameworks that resolve financial distress, including the FSB *Key Attributes of Effective Resolution Regimes for Financial*

⁶³ Treasury 2012, *Strengthening APRA's Crisis Management Powers: Consultation Paper*, Commonwealth of Australia, Canberra.

⁶⁴ Stevens, G 2012, 'Review of Financial Market Infrastructure Regulation', letter to The Hon. Wayne Swan, MP, Deputy Prime Minister and Treasurer, 10 February.

Financial System Inquiry — Final report

Institutions (Key Attributes).⁶⁵ Although Australia has strong frameworks, the reviews identified gaps and areas that could be strengthened.

The Government consultation paper *Strengthening APRA's crisis management powers* canvassed a number of options in relation to all APRA-regulated industries. The package does not include statutory bail-in powers outlined in the Key Attributes or general structural requirements, such as ring-fencing, being pursued in some jurisdictions. It includes:

- Directions powers, including clarifying that APRA may direct a regulated institution to pre-position for resolution – that is, require changes at an institution to make it more feasible to successfully resolve that institution if it were to fail.
- Group resolution powers, including extending certain powers to authorised non-operating holding companies (NOHCs) and subsidiaries in a range of distress situations.
- Powers to assist with resolving branches of foreign banks.

The CFR recommendations for strengthening the crisis management framework for FMI included:

- Introducing a specialised resolution regime for FMI.
- Clarifying the application of location requirements for FMI operating across borders.

Since these processes were put on hold, international developments have included updates to the Key Attributes, yielding additional guidance on areas such as cross-border information sharing, and resolving FMI and FMI participants. Some countries have also introduced structural reforms, such as mandating a form of ring-fencing, or a NOHC structure for institutions with certain risk profiles or of a certain size, with the aim of improving resolvability. These approaches emphasise reducing risks to core banking activities from more complicated and risky forms of banking, and simplifying institutions to make them more easily resolved.

Conclusion

The Inquiry believes progressing the packages would deliver a substantial net benefit. A range of resolution options – more ‘tools in the toolkit’ – would maximise the likelihood that a viable option will be available in any given situation to achieve an orderly resolution. The Inquiry notes the high costs associated with the disorderly failure of an institution, particularly where this creates financial system instability or

⁶⁵ Financial Stability Board (FSB) 2014, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, FSB, Basel.

the need for Government support. The Inquiry also notes that many of the proposed powers would have a limited regulatory burden in normal times.

In relation to the package of resolution powers for APRA, industry submissions largely support the package, although they raise practical and legal issues with some of the proposals.⁶⁶

APRA's submission to the Inquiry stresses the vital role that crisis management powers play in the prudential framework.⁶⁷ In any future crisis, these reforms would provide a wider range of tools, making it more likely that a credible, low-cost option for preventing a disorderly failure could be found, without risking taxpayer funds.

The RBA advocates for progressing the CFR proposals on FMI regulation as a matter of priority.⁶⁸ It notes that the continuity of FMI services is critical for the financial system to function. In addition, the RBA notes that, where FMI is domiciled offshore, Australian regulators need to have sufficient influence to prevent Australian functions from being compromised in a resolution.

The Inquiry does not recommend pursuing industry-wide structural reforms such as ring-fencing. These measures can have high costs, and require changes for all institutions regardless of the institution-specific risks. Neither APRA nor the RBA nor the banking industry saw a strong case for these reforms.

Nevertheless, APRA submits that it may be beneficial to require structural changes for specific institutions in some situations, where substantial risks or significant organisational complexity may impede supervision or an orderly resolution. The powers included in the consultation package provide sufficient flexibility to do this effectively.

Given the time that has passed since the initial consultation in progressing the reform packages – in particular, the considerable international developments over this period – a view should be taken as to whether additional proposals warrant inclusion.

All proposals should go through the appropriate consultation, regulatory assessment and compliance cost assessment processes.

66 Submissions on the consultation paper are available on the Treasury website, viewed 11 November 2014, <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/APRA/Submissions>>.

67 Australian Prudential Regulation Authority 2014, Second round submission to the Financial System Inquiry, page 38.

68 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 4.

Financial Claims Scheme

Recommendation 6

Maintain the ex post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.

Description

Government should retain the current FCS funding model for ADIs, under which payouts are recovered from liquidating the failed ADI and, where this is insufficient, an ad hoc levy can be placed on the banking industry.

Objectives

- Ensure the FCS has an appropriate and efficient funding structure.
- Minimise the ongoing regulatory costs of the FCS.

Problem the recommendation seeks to address

The FCS is a fundamental component in protecting depositors in Australia, providing a guarantee on deposits of up to \$250,000 per account holder per ADI. The FCS allows depositors to access protected deposits quickly, without having to wait for a liquidation process to be completed.

Currently the FCS is funded ex post. If an ADI fails and the FCS is activated, Government provides the necessary funds and then reclaims them from the proceeds of liquidating the institution. Where the liquidation proceeds are insufficient, Government can place a levy on industry to make further recoveries.

A number of bodies, including the IMF and the CFR, proposed an alternative ex ante funding model, which is also being consulted on by the International Association of Deposit Insurers.⁶⁹ The former Government also announced it would adopt ex ante funding.⁷⁰ Under this model, ADIs with FCS-protected funds would be charged an ongoing levy to compensate for the guarantee the FCS provides.

69 International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF, Washington DC; Basel Committee on Banking Supervision and International Association of Deposit Insurers 2014, *Core Principles for Effective Deposit Insurance Systems*, Bank for International Settlements, Basel.

70 Commonwealth of Australia 2013, *Economic Statement, August 2013*, statement by the Hon. Chris Bowen MP and Senator the Hon. Penny Wong, Canberra.

Conclusion

The proposed ex ante funding model has a number of appealing features, including:

- Being based on a user-pays principle.
- Enabling levy funds to be deployed to aid in wider ADI resolution purposes.
- Offering the potential to build a fiscal buffer.

However, an ex ante levy would be an ongoing cost for all ADIs. In contrast, the current ex post model only imposes a levy if the FCS is triggered and insufficient funds are recovered through liquidation to recoup the costs. Because Australia's depositor preference arrangements reduce the risk of an ADI's assets being insufficient to meet insured deposits, the case for an ongoing levy is less justified.

The Inquiry notes that the recommendations in this chapter would further strengthen the resilience of the Australian banking sector by reducing the risk of failure and mitigating the costs of failures that do occur. If adopted, these recommendations weaken the case to charge an ex ante levy for the FCS.

The Inquiry notes that the consultation package outlined in *Recommendation 5: Crisis management toolkit*, includes a number of measures designed to strengthen the FCS and Government's ability to recoup costs. These include an additional payment option that allows APRA to transfer deposits to a new institution using the funding available under the FCS.

On this basis, in the Inquiry's view, it is preferable to retain an ex post funding model that avoids placing an ongoing financial burden on the industry.

Leverage ratio

Recommendation 7

Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions' risk-weighted capital positions.

Description

APRA should introduce a leverage ratio as a backstop requirement, providing a floor to ADIs' risk-weighted capital requirements. This should be introduced as part of Australia's adoption of the Basel framework and in line with the international timetable.

The minimum leverage ratio should be comparable with Australia's global peers. In the Inquiry's view, an appropriate range is likely to be 3–5 per cent, calculated in accordance with the Basel framework.

Objectives

- Limit systemic risk and the potential for shocks to be transmitted through the financial system.
- Retain the risk sensitivity of capital requirements, while providing a mechanism that accounts for limitations and risks in modelling risk weights.
- Maintain investor confidence in the strength of Australian banks.

Problem the recommendation seeks to address

Leverage is a useful and necessary part of the banking system. It allows a bank to take savers' funds — whether in the form of deposits or creditors lending to the bank — and channel them to borrowers to fund investment in the economy. However, leverage also introduces risks. A highly leveraged institution has smaller buffers available to absorb loss before insolvency. Leverage can also amplify the effect of shocks on an institution's balance sheet. This may spread shocks to other institutions and cause systemic risks.

A number of countries have introduced leverage ratios, including the United States, the United Kingdom and Canada. Australia does not currently have a minimum leverage ratio requirement, although APRA has indicated that it may introduce one in line with the Basel framework. Details of how this would operate are being reviewed internationally.

Currently in Australia, restrictions on leverage are achieved indirectly by ensuring ADIs use capital funding in proportion with risk. In the Inquiry's view, the practice of relating capital requirements to risk is appropriate.

However, there are concerns that, in some instances, the risk-weighted approach may lead to insufficient levels of capital.⁷¹ This danger is possible under the standardised or IRB approach, but is greatest for IRB models, as there is potential for 'model risk'. For example, if the historical data are too benign, the models that underlie the risk-weighting system may underestimate the true risk, leading to inappropriately low levels of capital.⁷² Concerns have also been raised that banks may have the capacity – and incentive – to manipulate IRB models to achieve a lower capital requirement.

Studies have revealed substantial variation among IRB risk-weight models across countries.⁷³ Although this does not suggest IRB models are unsuitable, it does give reason to be cautious about their outputs.

A number of ADIs support having capital requirements commensurate with risk, meaning that capital requirements should generally be determined by the risk-weighted capital ratio. Similarly, APRA supports the principle of aligning capital with risk, being the primary driver of bank capital positions.

Both options would introduce monitoring and reporting costs for ADIs, although these are not expected to be large. As a backstop, the leverage ratio would not generally require ADIs to change their level of capital.

Conclusion

Whether a leverage ratio is a binding constraint or a backstop to the risk-weighted approach, the benefits are similar. Both options discourage excessive leverage and protect against risk being substantially underestimated, leading to weaker capital positions. However, the costs and risks will be greater with a binding constraint.

In the Inquiry's view, having a leverage ratio as a meaningful backstop provides appropriate insurance against the risks inherent in risk-based capital requirements, while retaining the advantages of having capital requirements commensurate with risk.

71 For example Tarullo, D 2014, *Rethinking the aims of prudential regulation*, speech at the Federal Reserve Bank of Chicago Bank Structure Conference, 8 May, Chicago.

72 Byres, W 2012, *Regulatory reforms – incentives matter (can we make bankers more like pilots?)*, remarks to the Bank of Portugal conference on Global Risk Management: Governance and Control, 24 October, Lisbon.

73 Basel Committee on Banking Supervision 2013, *Regulatory Consistency Assessment Programme (RCAP): Analysis of risk-weighted assets for credit risk in the banking book*, Bank for International Settlements, Basel.

Direct borrowing by superannuation funds

Recommendation 8

Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.

Description

Government should restore the general prohibition on direct borrowing by superannuation funds by removing Section 67A of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) on a prospective basis.⁷⁴ This section allows superannuation funds to borrow directly using limited recourse borrowing arrangements (LRBAs). The exception of temporary borrowing by superannuation funds for short-term liquidity management purposes (contained in Section 67 of the SIS Act) should remain.

Direct borrowing in this context refers to any arrangement that funds enter into where the borrowing is used to purchase assets directly for the fund.

Objectives

- Prevent the unnecessary build-up of risk in the superannuation system and the financial system more broadly.
- Fulfil the objective for superannuation to be a savings vehicle for retirement income, rather than a broader wealth management vehicle (see *Recommendation 9: Objectives of the superannuation system* in *Chapter 2: Superannuation and retirement incomes*).

⁷⁴ The term 'borrowing' includes all loans as defined by subsection 10(1) of the *SIS Act*.

Discussion

Problems the recommendation seeks to address

Further growth in superannuation funds' direct borrowing would, over time, increase risk in the financial system. As discussed in the Interim Report, the Inquiry notes an emerging trend of superannuation funds using LRBAs to purchase assets.⁷⁵ Over the past five years, the amount of funds borrowed using LRBAs increased almost 18 times, from \$497 million in June 2009 to \$8.7 billion in June 2014.⁷⁶ The limited recourse nature of these arrangements is intended to alleviate the risk of losses from assets purchased using a loan resulting in claims over other fund assets.

Borrowing, even with LRBAs, magnifies the gains and losses from fluctuations in the prices of assets held in funds and increases the probability of large losses within a fund. Because of the higher risks associated with limited recourse lending, lenders can charge higher interest rates and frequently require personal guarantees from trustees.^{77,78} In a scenario where there has been a significant reduction in the valuation of an asset that was purchased using a loan, trustees are likely to sell other assets of the fund to repay a lender, particularly if a personal guarantee is involved. As a result, LRBAs are generally unlikely to be effective in limiting losses on one asset from flowing through to other assets, either inside or outside the fund. In addition, borrowing by superannuation funds implicitly transfers some of the downside risk to taxpayers, who underwrite adverse outcomes in the superannuation system through the provision of the Age Pension.

Superannuation funds use diversification to reduce risk. Selling the fund's other assets will concentrate the asset mix of the fund – small funds that borrow are already more likely to have a concentrated asset mix.⁷⁹ This reduces the benefits of diversification and further increases the amount of risk in the fund's portfolio of assets.

The GFC highlighted the benefits of Australia's largely unleveraged superannuation system. The absence of leverage in superannuation funds meant that rapid falls in asset prices and losses in funds were neither amplified nor forced to be realised. The absence of borrowing benefited superannuation fund members and enabled the superannuation system to have a stabilising influence on the broader financial system and the economy during the GFC. Although the level of borrowing is currently

75 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-116.

76 Australian Taxation Office (ATO) 2014, *Self-managed superannuation fund statistical report – June 2014 (Asset allocation tables)*, ATO, viewed 28 October 2014, <<https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Quarterly-reports/Self-managed-super-fund-statistical-report---June-2014/>>.

77 The lending institution can only make a claim on the asset against which a loan is made and does not have recourse to make claims on the other assets held in the fund.

78 Reserve Bank of Australia 2014, First round submission to the Financial System Inquiry, page 185.

79 Rice Warner 2014, Second round submission to the Financial System Inquiry, page 30.

relatively small, if direct borrowing by funds continues to grow at high rates, it could, over time, pose a risk to the financial system. The RBA states that “The Bank endorses the observation that leverage by superannuation funds may increase vulnerabilities in the financial system and supports the consideration of limiting leverage”.⁸⁰ In addition, such direct borrowing could also compromise the retirement incomes of individuals. APRA was of the view that “... the risks associated with direct leverage are incompatible with the objectives of superannuation and cannot adequately be managed within the superannuation prudential framework”.⁸¹

Borrowing by superannuation funds also allows members to circumvent contribution caps and accrue larger assets in the superannuation system in the long run (see the *Taxation of superannuation* discussion in *Chapter 2: Superannuation and retirement incomes*).

Conclusion

Direct borrowing by superannuation funds could pose risks to the financial system if it is allowed to grow at high rates. It is also inconsistent with the objectives of superannuation to be a savings vehicle for retirement income. Restoring the original prohibition on direct borrowing by superannuation funds would preserve the strengths and benefits the superannuation system has delivered to individuals, the financial system and the economy, and limit the risks to taxpayers.

Many submissions support this recommendation. Some propose alternatives to address the risks surrounding borrowing, including imposing a maximum cap on fund assets that can be invested in a single asset other than cash or bonds.^{82,83} These alternatives would limit the risk associated with borrowing by superannuation funds, and provide funds with more flexibility to pursue alternative investment strategies. However, these options would also impose additional regulation, complexity and compliance costs on the superannuation system.

In implementing this recommendation, funds with existing borrowings should be permitted to maintain those borrowings. Funds disposing of assets purchased via direct borrowing would be required to extinguish the associated debt at the same time.

80 Reserve Bank of Australia 2014, Second round submission to the Financial System Inquiry, page 20.

81 Australian Prudential Regulation Authority 2014, Second round submission to the Financial System Inquiry, page 32.

82 Barton Consultancy 2014, Second round submission to the Financial System Inquiry, page 3.

83 Rice Warner 2014, Second round submission to the Financial System Inquiry, page 30.

Chapter 2: Superannuation and retirement incomes

Australia needs an efficient superannuation system given the system's size and growth, the role it plays in funding the economy and its importance in delivering retirement incomes. The superannuation system is large by international standards and has grown rapidly since the Wallis Inquiry in 1997. It is the second largest part of the financial sector and, according to some forecasts, could have assets that exceed those of Australia's banking system within the next 20 years.¹

Australia's superannuation system has considerable strengths.² It plays an important role in providing long-term funding for economic activity in Australia – both directly and indirectly through funding financial institutions – and it contributed to the stability of the financial system and the economy during the global financial crisis (GFC).

Superannuation is also critical to help Australia meet the economic and fiscal challenges of an ageing population. Life expectancy in Australia is the fourth longest of any country, and is projected to continue to increase.^{3,4} There will be economic benefits if the growing proportion of older people can sustain their level of consumption in retirement.

The Inquiry sees scope to improve the efficiency of the superannuation system in a number of areas. The superannuation system is not operationally efficient due to a lack of strong price-based competition and, as a result, the benefits of its scale are not being fully realised. Substantially higher superannuation balances and fund consolidation over the past decade have not delivered the benefits that would have been expected; these benefits have been offset by higher costs elsewhere in the system rather than being reflected in lower fees. Other design features also contribute to inefficiencies,

1 Industry Super Australia, using information from Deloitte, forecasts superannuation assets will exceed those of the banking system by the early 2030s. Industry Super Australia 2014, First round submission to the Financial System Inquiry, page 117.

2 For example, the 2014 Melbourne Mercer Global Pension Index ranks Australia's superannuation system second out of 25 countries. Its rating of 'B+' describes "... a system that has a sound structure, with many good features, but has some areas for improvement that differentiates it from an A-grade system". Mercer 2014, *Melbourne Mercer Global Pension Index*, Australian Centre for Financial Studies, Melbourne, page 7.

3 United Nations 2013, *World Population Prospects: The 2012 Revision*, United Nations, viewed 12 November 2014, <<http://esa.un.org/wpp/Excel-Data/mortality.htm>>.

4 Commonwealth of Australia 2009, *Australian Life Tables 2005–07*, Canberra, page 17.

Financial System Inquiry — Final report

leading to higher costs and sub-optimal outcomes for members, such as the proliferation of multiple accounts.

Superannuation assets are not being efficiently converted into retirement incomes due to a lack of risk pooling and an over-reliance on account-based pensions. This contributes to a lower standard of living for Australians in retirement and, for some, during working life — meaning people may have to save more than they did previously to reach the same level of retirement income.

Tax concessions in the superannuation system are not well targeted at improving retirement incomes, which has a number of consequences. It increases the cost of the superannuation system to taxpayers; it increases distortions due to higher levels of taxation elsewhere in the economy and due to the differences in the way other savings vehicles are taxed; and it contributes to the broader problem of policy instability, which imposes unnecessary costs on superannuation funds and their members and undermines long-term confidence in the system.

In looking at superannuation policy settings from a financial system perspective, the Inquiry has also considered the associated social policy objectives. However, the Inquiry has not explicitly considered social policy settings, such as whether retirement incomes are adequate, or Age Pension policy settings, because these are outside the Inquiry's terms of reference. The Inquiry has also made observations about the effects of taxation policy on the superannuation system and has referred them to the Tax White Paper.

Recommended actions

The Inquiry sees significant scope for the superannuation system to meet the needs of superannuation fund members better and provide broader benefits to the financial system and the economy. Specifically, the Inquiry believes action can be taken in the following three areas:

- **Set clear objectives for the superannuation system.** A clear statement of the system's objectives is necessary to target policy settings better and make them more stable. Clearly articulated objectives that have broad community support would help to align policy settings, industry initiatives and community expectations.
- **Improve operational efficiency during accumulation.** Subject to the outcome of a review, a formal competitive process may be needed to allocate new default fund members to MySuper products.

A formal competitive process would extend competitive pressures from the wholesale default fund market to the broader default fund market and improve after-fee returns.⁵ It would also reduce costs for funds and compliance costs for employers, who would no longer be required to select default funds for employees.

This recommendation should only be implemented subject to the outcome of a review of the superannuation system's efficiency and competitiveness. This caveat acknowledges it is too early to assess the effectiveness of the Stronger Super reforms, although the Inquiry has reservations about whether these reforms alone will significantly improve system efficiency and member outcomes.

- **Improve efficiency in retirement.** Greater use of risk pooling could significantly increase retirement incomes generated from accumulated balances. This could allow individuals to allocate consumption throughout their lives better (greater *dynamic efficiency*) by reducing the savings required to achieve a target level of income in retirement. This could be achieved by:
 - Removing barriers to new product development.
 - Using behavioural biases to encourage rather than discourage the use of products that provide longevity risk protection.

This recommendation would involve trustees pre-selecting a comprehensive income product for retirement (CIPR) option for their members. Pre-selected options have been demonstrated to influence behaviour but do not limit personal choice and freedom. They would bring the policy philosophy at retirement closer to that of the accumulation phase.

Managing longevity risk through effective pooling in a CIPR could significantly increase private incomes for many Australians in retirement and provide retirees with the peace of mind that their income will endure throughout retirement, while still allowing them to retain some flexibility to meet unexpected expenses. An enduring income stream would give retirees the confidence to spend in retirement, which would help to sustain economic growth as the population ages and reduce the extent to which longevity risk falls on the taxpayer.

5 The wholesale default fund market refers to large corporations tendering for a default superannuation fund for their employees. Lower fees reflect the buying power of a large corporation and lower member acquisition costs for funds. Many award superannuation fund members similarly receive wholesale benefits through lower fees as a result of lower member acquisition costs.

Financial System Inquiry — Final report

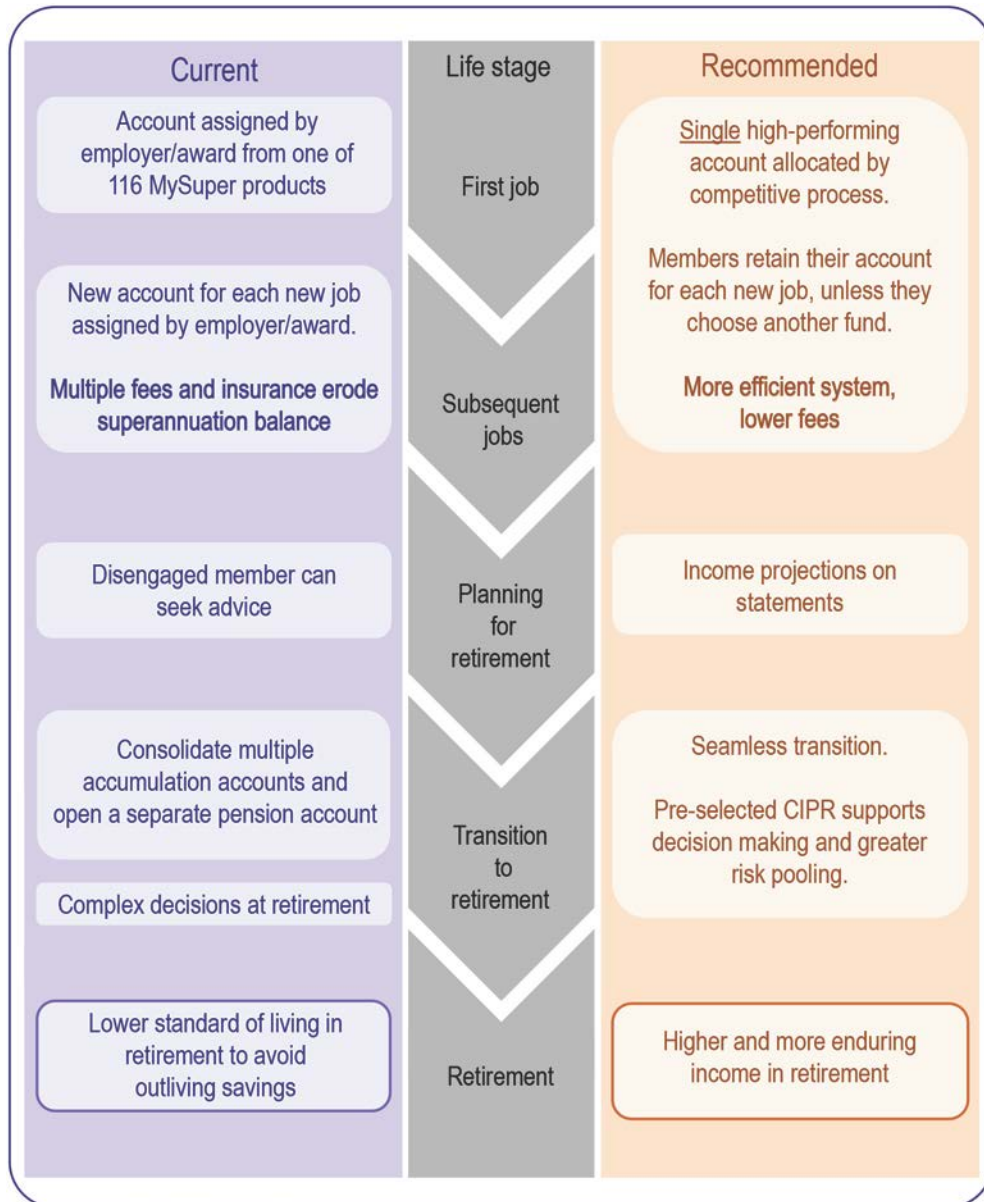
To support and complement these recommendations:

- All employees should be able to choose the superannuation fund that receives their Superannuation Guarantee (SG) contributions.
- Superannuation funds should provide retirement income projections on member statements to improve member engagement (recommended in *Appendix 1: Significant matters*).
- The Tax White Paper should consider the removal of tax barriers to a seamless transition to retirement and target superannuation tax concessions to the superannuation system's objectives. Adjustments to tax settings and efforts to improve equity have been major contributors to superannuation policy change in the past. The Inquiry believes community concerns about these issues need to be addressed to achieve greater policy stability and long-term confidence and trust in the system.

The package of superannuation measures, including introducing a formal competitive process to allocate new default fund members to MySuper products, would deliver better outcomes and a more seamless experience for superannuation members throughout their lives (illustrated for default fund members in *Figure 6: The superannuation system for default fund members*). This package has the potential to increase retirement income for a male on average weekly ordinary-time earnings by 25–40 per cent in retirement (excluding the Age Pension).⁶ While these estimates are illustrative and based on models which cannot fully reflect the unique circumstances of different individuals, the Inquiry is confident that significant increases in retirement incomes can be achieved. The package would also move the system's focus away from employers, towards individuals.

6 Estimates were prepared using Australian Government Actuary modelling and input from Treasury models. The benefits of lower superannuation fees and savings from maintaining a single superannuation account over a person's working life (discussed in *Recommendation 10: Improving efficiency during accumulation*) account for more than 10 percentage points, and the remaining portion reflects the use of a CIPR. The models compare retirement income from an account-based pension, drawn down at minimum rates, to the results from a CIPR. Increased income and improved risk management comes at a cost of reduced flexibility and smaller bequests from superannuation. Further details are provided in *Recommendation 11: The retirement phase of superannuation*. The combined effects over 37 years of work would be that annual retirement income (excluding the Age Pension) would increase from \$26,000 to between \$33,000 and \$38,000.

Figure 6: The superannuation system for default fund members



The Inquiry has also made recommendations to improve the resilience of, and confidence in, the superannuation system, including:

- Improving governance by requiring a majority of independent directors on superannuation trustee boards and aligning penalties for director misconduct with those of managed investment schemes (MISs).

Financial System Inquiry — Final report

- Improving the quality of financial advice and empowering consumers through improved disclosure and transparency (recommended in *Chapter 4: Consumer outcomes*).
- Restoring the prohibition on direct borrowing in superannuation funds to preserve an important strength of the superannuation system, which was demonstrated during the GFC (recommended in *Chapter 1: Resilience*).

Principles

In making its detailed recommendations, the Inquiry has been guided by the following principles:

- Government intervention in the superannuation system should support a clear objective to provide income in retirement.
- Retaining freedom and choice within a compulsory system is fundamental to meeting the needs of individual superannuation fund members, even though this may involve costs.
- The efficiency of the superannuation system should be improved by policy measures aimed at removing barriers to innovation and increasing competitive pressures.
- In designing superannuation policy settings, policy makers should recognise and respond to consumers' significant behavioural biases.
- Individuals should bear responsibility for their financial decisions.⁷ However, because of mandatory contributions and the implications of Age Pension outlays for taxpayers, Government has a responsibility to adopt policy settings that deliver appropriate outcomes for superannuation fund members.

Conclusion

Implementing the package of recommendations in this chapter, and continuing to develop policy based on the principles outlined above, would improve outcomes for superannuation fund members. The superannuation system would also support the stability of the financial system and help Australia to manage the economic and fiscal challenges of an ageing population.

⁷ Refer to *Chapter 4: Consumer outcomes* for more details.

Objectives of the superannuation system

Recommendation 9

Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.

Description

Government should seek broad agreement on the following primary objective for the superannuation system:

To provide income in retirement to substitute or supplement the Age Pension.

In achieving this primary objective, Government should also seek broad agreement on the subsidiary objectives of the superannuation system, as set out in Table 3.

Table 3: Subsidiary objectives of the superannuation system

Subsidiary objective	Why the objective is important
Facilitate consumption smoothing over the course of an individual's life	Superannuation is a vehicle for individuals to fund consumption in retirement largely from working life income. The system should facilitate consumption smoothing while providing choice and flexibility to meet individual needs and preferences.
Help people manage financial risks in retirement	Risk management is important as retirees generally have limited opportunities to replenish losses. The retirement income system should help individuals manage longevity risk, investment risk and inflation risk. Products with risk pooling would help people to manage longevity risk efficiently.
Be fully funded from savings	A fully funded system, as opposed to an unfunded system, is important for sustainability and stability. The system is designed to be predominantly funded by savings from working life income and investment earnings, where superannuation fund members in general have claims on all assets in the fund.
Be invested in the best interests of superannuation fund members	Superannuation funds are managed for the sole benefit of members, which means the investment focus should be on maximising risk-adjusted returns, net of fees and taxes, over the lifetime of a member. This results in auxiliary benefits to the economy by creating a pool of savings to fund long-term investment.
Alleviate fiscal pressures on Government from the retirement income system	Government's total contribution to the retirement income system, through both the Age Pension and superannuation tax concessions, needs to be sustainable and targeted. Higher private provisioning for retirement should reduce the burden on public finances.
Be simple and efficient, and provide safeguards	The system should achieve its objectives at the minimum cost to individuals and taxpayers. Complexity is less appropriate for a compulsory system, as it tends to add to costs and to favour sophisticated and well-informed investors. Given the compulsory nature of SG contributions, the system needs prudential oversight and should provide good outcomes in both the accumulation and retirement phases for disengaged fund members.

Financial System Inquiry — Final report

The superannuation system spans two of the three pillars of Australia's retirement income system: the mandatory savings pillar and the voluntary savings pillar.⁸

Objectives

- Provide a framework for evaluating the efficiency and effectiveness of the superannuation system.
- Contribute to greater long-term confidence and policy stability through agreed objectives, against which superannuation policy proposals can be assessed.

Discussion

Problem the recommendation seeks to address

The superannuation system does not have a consistent set of policies that work towards common objectives. For example, the current framework provides significant support and guidance to superannuation fund members during the accumulation phase through mandatory savings and default arrangements. However, the framework does not provide the same degree of support at retirement, when individuals confront a complex set of financial decisions.

The lack of an agreed policy framework and objectives reduces the efficiency of the system. Submissions acknowledge that this lack of clear purpose is affecting the operational efficiency of the system. Some submissions state:

Without clarity of purpose, superannuation and retirement policy and regulatory architecture cannot be aligned and, therefore, cannot deliver the right outcomes. This ultimately drives up costs and complexity.⁹

A coherent overarching framework will allow development of an efficient long-term strategy and reduce the incidence of short-term policy changes.¹⁰

The absence of agreed objectives contributes to short-term ad hoc policy making. It adds complexity, imposes unnecessary costs on superannuation funds and their

8 As discussed in the Interim Report, the three pillars comprise the Age Pension, mandatory SG contributions and voluntary savings, both inside and outside superannuation. The mandatory superannuation pillar ensures a minimum level of retirement savings by employees and the voluntary savings pillar enables individuals to tailor additional savings to achieve their individual goals. Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-97.

9 Association of Superannuation Funds of Australia 2014, Second round submission to the Financial System Inquiry, page 6.

10 Actuaries Institute 2014, First round submission to the Financial System Inquiry, attachment, page 4.

Chapter 2: Superannuation and retirement incomes

members, and undermines long-term confidence in the system. Submissions note that many superannuation policies have been introduced and then subsequently repealed or amended (in some cases, repeatedly). One submission states:

*Constant short-term change involves a significant and perhaps unnecessary cost for the industry and consumers to bear.*¹¹

The lack of an agreed policy framework also increases the cost of the superannuation system to Government because tax concessions are not being efficiently targeted at meeting the system's objectives.

Rationale

Clearly defining the objectives of the superannuation system is a prerequisite to achieving the objectives efficiently. Consistent policy settings across the accumulation and retirement phases would meet the retirement income needs of Australians more efficiently and effectively. It would also assist Government in implementing policy settings that are well targeted and sustainable over the long term. One submission notes:

*Defining the objectives of superannuation will allow the efficacy of the retirement income system to be measured. It will also enable a more reasoned assessment of the need for future policy changes and hopefully see an end to the ad hoc policy tinkering of the past two decades. The articulation of the objectives and system design principles will also help foster a bi-partisan, enduring commitment to the superannuation system, ensuring stability and long-term confidence in the system.*¹²

Objectives that guide policy making and frame community and industry debate would help build confidence in the system by providing a framework for considered and cohesive change. Greater clarity around objectives can help reduce complexity and costs in the system. Importantly, in supporting greater policy stability, the Inquiry is not seeking to avoid future change. The system needs to adapt to changing circumstances but avoid unnecessary or ad hoc changes that cannot be sustained over time.

Options considered

1. **Recommended:** Seek broad political agreement for the objectives of the superannuation system.

11 Actuaries Institute 2014, First round submission to the Financial System Inquiry, page 4.

12 Australian Institute of Superannuation Trustees 2014, Second round submission to the Financial System Inquiry, attachment, page 5.

2. **Recommended:** Enshrine the objectives in legislation. Government should report publicly on how policy proposals are consistent with achieving the objectives in the long term.
3. Establish a publicly funded independent body to assess the superannuation system's performance and report on superannuation policy changes.

Option costs and benefits

Seek broad political agreement for the objectives of the superannuation system

Given superannuation is both compulsory and a tax-preferred long-term savings vehicle, Government has a clear role in defining the system's objectives.

Submissions agree that articulating clear objectives is a critical step towards greater policy consistency and stability, and a prerequisite to achieving the objectives efficiently. In general, submissions nominate two major objectives: providing income in retirement and reducing pressure on the Age Pension. A number of stakeholders raise the importance of the superannuation system for national savings and funding economic activity. However, funding economic activity is a consequence of a well-designed long-term savings vehicle that invests in the interests of its members, rather than an objective in itself.

The Inquiry's single primary objective prioritises the provision of retirement incomes and precludes the pursuit of other objectives at the expense of retirement incomes. It will help reorient the community mindset around superannuation, away from account balances and towards the provision of retirement incomes. Nobel Laureate Robert Merton wrote: "Sustainable income flow, not the stock of wealth, is the objective that counts for retirement planning".¹³

Assessing the current superannuation system against the primary and subsidiary objectives outlined in this chapter identified a number of weaknesses that have given rise to recommendations in this report. These include the lack of focus on retirement incomes over other objectives, the lack of operational efficiency in the system, the lack of risk management in retirement, the inefficiency in converting wealth to retirement income, the ability of superannuation funds to borrow rather than be fully funded from savings, poorly targeted tax concessions, and safeguards that could be strengthened to assist members.

Enshrine the objectives in legislation and provide more Government reporting

Submissions strongly agree with the need for greater policy stability to promote long-term confidence in the system. Submissions also acknowledge that the ability to

13 Merton, R 2008, *The Future of Retirement Planning*, CFA Institute: Research Foundation Publications, vol. 2008, no. 1, page 11.

respond to changing circumstances is important but that new policies must be well considered and take a long-term perspective.

Enshrining the primary and subsidiary objectives in legislation would provide a framework against which Government and the broader community could assess superannuation policy proposals. Parliamentary approval would be required to amend the objectives over time.

Increased transparency around the objectives of policy proposals would help frame parliamentary and public debate. This could be done in regulatory impact statements at little cost. In addition, Government could periodically assess the extent to which the superannuation system is meeting its objectives. This could be done in a stand-alone report or as part of the Intergenerational Report, which is prepared every five years.

Establish a publicly funded independent body to assess the superannuation system's performance and report on superannuation policy changes

A number of submissions suggest establishing an independent authority for retirement incomes. The authority would publish data, conduct research and analysis relevant to retirement incomes policy, and assess policy changes or proposals over the long term. Some stakeholders go further and propose that such a body should be responsible for developing policy.

However, the Inquiry has concerns about the appropriate accountability mechanisms for such an agency. It is difficult to set a mandate and target for an independent body due to the complex trade-offs between stakeholder interests and policy objectives. The Inquiry has not seen strong evidence that an independent body would significantly improve policy outcomes. Establishing and operating a new authority would involve costs to Government.

Conclusion

Defining the objectives of the superannuation system is necessary to build an efficient superannuation system. The Inquiry recommends greater reporting by Government on how policy proposals better fulfil the objectives of the system over the long term. Stating the objectives would also help to align community expectations and industry initiatives with policy settings.

The Inquiry recommends that the Tax White Paper consider the objectives of the superannuation system when evaluating superannuation tax policy proposals.

Implementation considerations

A first step towards obtaining broad political agreement to superannuation system objectives could be to establish a joint parliamentary inquiry to consider the proposed objectives and make a recommendation to Parliament. Parliament could enshrine the objectives in the preamble to a major piece of superannuation legislation

Financial System Inquiry — Final report

or in another instrument or charter. However, stating the objectives of the superannuation system in legislation is only intended to guide the policy-making process and is not intended to provide a platform for courts to reinterpret the law.

Improving efficiency during accumulation

Recommendation 10

Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.

Description

Subject to the findings of a review of the efficiency and competitiveness of the superannuation system, Government should introduce a formal competitive process to allocate new workforce entrants to MySuper products. The competitive process could be an auction or tender. Current default fund members would also benefit as funds would not be allowed to price discriminate between their existing and new MySuper members. This competitive process would replace the industrial relations system in selecting default superannuation funds for workers.

The Productivity Commission (PC) should hold an inquiry by 2020, following the full implementation of MySuper (part of the Stronger Super reforms) to determine whether further reform would be beneficial.

Objective

- Enhance efficiency in the superannuation system to improve long-term net returns to members and build trust and confidence in funds regulated by the Australian Prudential Regulation Authority (APRA).

Discussion

Problems the recommendation seeks to address

As discussed in the Interim Report, funds could lower fees without compromising returns to members.¹⁴ Fees have not fallen by as much as would be expected given the substantial increase in the scale of the superannuation system. As noted by the Super System Review, a major reason for this is the absence of strong consumer-driven

14 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-100.

Financial System Inquiry — Final report

competition, particularly in the default fund market.¹⁵ This reflects members' lack of engagement and reliance on employers to choose default funds for their employees.

The Stronger Super reforms implemented in response to the Super System Review aimed to address these issues. Although it is too early to draw firm conclusions, the Inquiry has some reservations about how effective these reforms will be in generating competition and the extent to which they will improve after-fee returns for members.

In the Interim Report, the Inquiry compared the fees in Australia to those overseas. Submissions challenge the observation that operating costs and fees appear high by international standards. They argue that the different features and structures of pension systems globally make comparisons difficult. A Deloitte Access Economics report, commissioned by the Financial Services Council, argues "... fees can be driven by a number of factors, and may not be directly comparable across jurisdictions".¹⁶ The Inquiry accepts many of these arguments and acknowledges that some unique features of the Australian system contribute to elevated costs and therefore higher fees.

Other submissions attempt to make international comparisons across funds. The Association of Superannuation Funds of Australia (ASFA) states, "In international terms, Australian defined contribution (DC) members are paying fees consistent with members of similar funds overseas".¹⁷ Since the Australian superannuation system is several times larger than DC systems overseas, Australian funds could be expected to have lower fees after accounting for differences in features.¹⁸

A major concern of the Inquiry, shared by the Super System Review, is that the Australian system as a whole has been unable to realise the full benefits of scale. The Deloitte Access Economics report concludes, "... using international experiences as a benchmark, it appears that there may be scope for lower fees in the Australian system".¹⁹ If fees and costs could be reduced, net returns, and ultimately retirement incomes, could be higher.

In some cases, higher costs and fees may be in the interests of members. For example, alternative asset classes, such as infrastructure and other unlisted investments, tend to

15 Commonwealth of Australia 2010, *Super System Review Final Report, Part One: Overview and Recommendations*, Canberra, page 7.

16 Deloitte Access Economics 2014, *Financial performance of Australia's superannuation products*, Financial Services Council, Canberra, page 6.

17 Association of Superannuation Funds of Australia 2014, Second round submission to the Financial System Inquiry, page 5.

18 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-100, Chart 4.1.

19 Deloitte Access Economics 2014, *Financial performance of Australia's superannuation products*, Financial Services Council, Canberra, page 6.

be more expensive to manage, but they may also diversify risks and offer higher after-fee returns for members. Submissions support this point.²⁰

Factors driving higher costs and fees and a lack of price-based competition in Australia include:

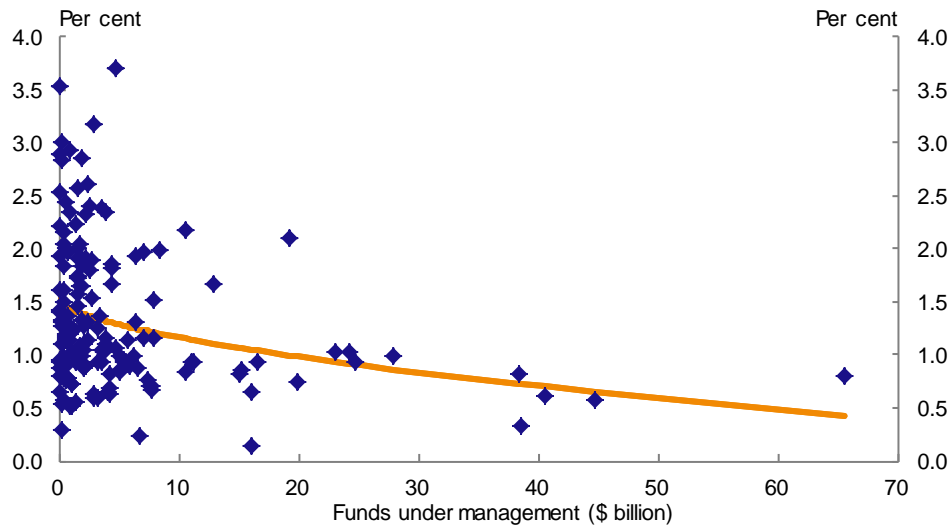
- **Supply-side issues:** market fragmentation; costly asset management and active investment strategies; taxation and provision of insurance; and government policy changes.
- **Demand-side issues:** weak member-driven competition due to lack of member interest; complexity; lack of comparability of fees and performance; and agency and structural problems.

Market fragmentation increases costs

The fragmented nature of the Australian superannuation system has limited the extent to which superannuation fund members benefit from scale economies, notwithstanding recent fund consolidations. This contributes to higher fees and lower after-fee returns to members. Australia has 294 APRA-regulated funds, most of which have a small asset base and tend to have higher fees than larger funds (*Chart 2: Fees by fund size*).^{21,22} In June 2013, around 80 per cent of these APRA-regulated superannuation funds held only around 20 per cent of assets.^{23,24}

-
- 20 For example, Financial Services Council 2014, Second round submission to the Financial System Inquiry, Chapter 1, page 27; SuperRatings 2014, Second round submission to the Financial System Inquiry, page 15; Australian Institute of Superannuation Trustees 2014, Second round submission to the Financial System Inquiry, page 19; Mercer 2014, Second round submission to the Financial System Inquiry, page 25.
- 21 In this report, APRA-regulated funds refers to only those with more than four members.
- 22 Australian Prudential Regulation Authority (APRA) 2014, *Statistics: Quarterly Superannuation Performance (interim edition)*, June ed., APRA, Sydney, page 8.
- 23 Australian Prudential Regulation Authority (APRA) 2013, *Superannuation Fund-level Rates of Return*, June ed., APRA, Sydney, pages 5–9.
- 24 Australian Prudential Regulation Authority (APRA) 2014, *Statistics: Quarterly Superannuation Performance (interim edition)*, June ed., APRA, Sydney, page 8.

Chart 2: Fees by fund size
 APRA-regulated funds, as at 30 June 2013 for a \$50,000 balance



Source: Rice Warner.²⁵ Line of best fit added by Financial System Inquiry.

The substantial expansion in the scale of the superannuation system over the past decade could have been expected to significantly lower fees for fund members. The size of the average fund increased from \$260 million in assets in 2004 to \$3.3 billion in 2013, whereas average fees fell by 20 basis points over the same period.^{26,27} This point was highlighted in the Interim Report but not widely addressed in second round submissions. Rice Warner estimates that system growth and scale could have reduced fees by 45 basis points.²⁸ Two-thirds of the estimated benefits from scale and lower margins over the past decade have been offset by increases in fund costs (*Figure 7: Drivers of changes in average fees between 2004 and 2013*).²⁹

25 Rice Warner 2014, *MySuper Fees*, Data provided to the Financial System Inquiry, 6 November 2014.

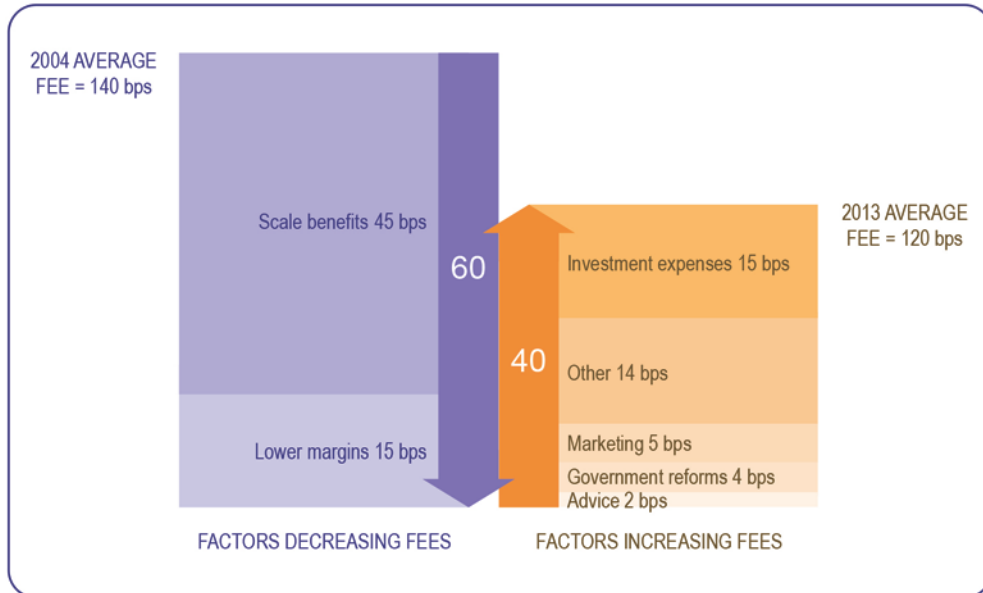
26 Entities with more than four members. Australian Prudential Regulation Authority (APRA) 2014, Data provided to the Financial System Inquiry, 3 June 2014.

27 Rice Warner 2014, Data provided to the Financial System Inquiry, 17 June 2014.

28 Estimate based on data from Rice Warner 2014, *MySuper Fees*, Data provided to the Financial System Inquiry, 6 November 2014.

29 Rice Warner 2014, *Superannuation Fees*, Data provided to the Financial System Inquiry, 23 July 2014.

Figure 7: Drivers of changes in average fees between 2004 and 2013
APRA-regulated funds; basis points (bps)



Source: Rice Warner.³⁰

Weak member-driven competition

Australia's superannuation system is different from a traditional competitive market. Compulsory contributions, coupled with a complex system, contribute to disengaged consumers and weak member-driven competition. A high degree of fragmentation has persisted because of the lack of strong competitive pressures. This is widely recognised in submissions. ASFA explains, "In an efficient market, consumers (members) would move away from less cost efficient funds to more cost efficient funds, eventually driving merger activity. However, without engagement, the expected customer movement away from these higher cost funds will not happen, removing a potential driver of merger activity".³¹

Agency and structural issues

Another factor contributing to the lack of member-driven competition is the role of employers in selecting default funds. Although the benefits from a fund's performance fully accrue to employees, much of the costs of administering SG contributions are borne by employers. For this reason, the PC's inquiry into default superannuation funds in modern awards found employers "... might have little incentive to invest

30 Rice Warner 2014, *Superannuation Fees*, Data provided to the Financial System Inquiry, 23 July 2014.

31 Association of Superannuation Funds of Australia 2014, Second round submission to the Financial System Inquiry, page 16.

Financial System Inquiry — Final report

time and effort into making choices that are in the best interests of their employees". The PC also found that employers face high search costs, may lack information and expertise to make an appropriate choice for their employees and may choose a fund based on auxiliary benefits specific to the employer, such as low administrative requirements.³²

Although employers, as agents for their employees, are generally ineffective in driving competition in the superannuation market, there are exceptions. Some large corporations tender for their default fund to obtain wholesale fee discounts for employees. ASFA notes, "Fee-based competition has always been strong in the tender processes for default funds that have been undertaken by large employers".³³ In addition, some default funds specified in awards effectively benefit from lower member acquisition costs to obtain wholesale fee discounts for employees. As a result, an individual's employer can have a significant bearing on their retirement income.

Preliminary evidence on the effectiveness of MySuper and SuperStream reforms

The Super System Review's recommendations aimed to address many of the issues above. MySuper was introduced as a simple, low-cost, default superannuation product. SuperStream will reduce costs by streamlining the administrative functions of superannuation funds. Other elements of the Stronger Super reforms included measures to improve fee transparency and fund governance.³⁴ The Super System Review argued that its package of reforms could reduce fees by up to 70 basis points for the most expensive investment options in larger funds.³⁵

The Inquiry agrees with many submissions that it is too early to draw firm conclusions about the long-term effects of these reforms on average fees and net returns to members. Funds have only been able to offer MySuper products since 1 July 2013 and many are still absorbing one-off costs of the reforms. Additionally, accrued default amounts do not need to be rolled over into MySuper products until 2017.

Preliminary evidence shows a net reduction in average MySuper fees against comparable default options of 15 basis points between 30 June 2011 and 31 March 2014.³⁶ The fall in average fees between 2011 and 2014 reflected a reduction

32 Productivity Commission 2012, *Default Superannuation Funds in Modern Awards: Productivity Commission Inquiry Report*, Commonwealth of Australia, Canberra, page 60.

33 Association of Superannuation Funds of Australia 2014, Second round submission to the Financial System Inquiry, page 39.

34 Commonwealth of Australia 2010, *Stronger Super*, Canberra, pages 15–63.

35 Commonwealth of Australia 2010, *Super System Review Final Report, Part One: Overview and Recommendations*, Canberra, page 19.

36 Based on a \$50,000 balance. Rice Warner 2014, *MySuper Fees*, Data provided to the Financial System Inquiry, 6 November 2014, page 6, Table 4.

in asset-based fees, which were partially offset by higher fixed-dollar fees. Three of the four market segments increased fees in default products between 2011 and 2014.³⁷

The Inquiry has some reservations about whether the legislated MySuper reforms will significantly improve the competitive dynamics and efficiency of the superannuation system and realise the full benefits of scale, as follows:

- Despite some early signs of fee reductions, the fees offered on MySuper products still vary widely, with a difference of 136 basis points between the highest and lowest fees (*Chart 3: Range of MySuper fees*).³⁸ Differences in asset allocation and investment strategy could account for variations in fees. However, data suggests that higher MySuper investment fees do not strongly correlate with the allocation to growth assets.³⁹
- The reduction in MySuper fees against comparable default options appears to have been largely due to the Future of Financial Advice reforms prohibiting commissions in MySuper products, rather than the introduction of MySuper. Removing these commissions is estimated to reduce fees by 25 basis points, which exceeds the estimated reduction in fees to date for default products.⁴⁰ However, the reduction in MySuper fees from removing commissions will not be fully realised until all accrued default amounts are moved to MySuper products, which is required to be completed by 2017.

There is a risk that some MySuper fee reductions are at the expense of member returns through changes in asset allocation and investment strategy.⁴¹ Furthermore, MySuper trustees are required to consider annually whether members are disadvantaged by the fund's scale compared to MySuper members in other funds.⁴² It is questionable whether this requirement will be sufficient to drive significant fund consolidation in the absence of stronger competitive pressures.

37 Rice Warner 2014, *MySuper Fees*, Data provided to the Financial System Inquiry, 6 November 2014.

38 Note that there are differences between the data used by Rice Warner and the MySuper data for June 2014 published by the Australian Prudential Regulation Authority (APRA). This reflects recent updates to data and differences in reporting fees between APRA's data and product disclosure statements.

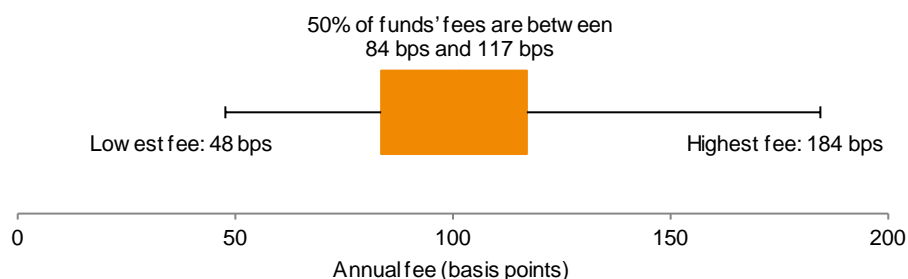
39 Rice Warner 2014, *MySuper Fees*, Data provided to the Financial System Inquiry, 6 November 2014, page 10, Graph 3.

40 Rice Warner 2014, *MySuper Fees*, Data provided to the Financial System Inquiry, 6 November 2014.

41 For example, some MySuper products have benchmark asset allocations to cash and fixed income of up to 50 per cent. Australian Prudential Regulation Authority (APRA) 2014, *Quarterly MySuper Statistics, June 2014*, APRA, Sydney.

42 *Superannuation Industry (Supervision) Act 1993*, s29VN(b).

Chart 3: Range of MySuper fees
For a \$50,000 balance in 2014



Source: Rice Warner, using a combination of APRA data and product disclosure statement information.⁴³

Rationale

Government intervention in the superannuation system is warranted to improve the system's efficiency in the accumulation phase. The system lacks traditional market forces, due in part to substantial Government intervention. Also, the outcomes of the superannuation system ultimately affect both its members and taxpayers through the level of Age Pension payments.

A more efficient system would ensure that all default fund employees, including the disengaged, receive the benefits of wholesale competition — not only employees of certain large corporations and those covered by modern awards. It would also allow individuals to retain a single account throughout their working life to avoid paying multiple fees. Finally, it would mean the majority of future scale economies would benefit members through lower fees and higher retirement incomes, rather than being eroded by higher costs.

Fees can have a significant effect on retirement incomes and the total level of superannuation savings. For example, if average fees in APRA-regulated funds were reduced by 30 basis points, this would increase total member balances and funds available for long-term investment by more than \$3.5 billion per annum.⁴⁴ Such a fee

43 Rice Warner 2014, *MySuper Fees*, Data provided to the Financial System Inquiry, 6 November 2014.

44 A reduction in fees of 30 basis points corresponds to the difference between the average fee of the top quartile of MySuper products and all MySuper products. The fee reduction could be achieved through a formal competitive process, in part by better realising scale benefits. By comparison, Rice Warner estimates potential scale benefits in the superannuation sector of 20 basis points over the next four years: Rice Warner 2014, *MySuper Fees*, Data provided to the Financial System Inquiry, 6 November 2014. The 30 basis point fee reduction has been applied to assets of \$1.2 trillion in APRA-regulated funds as at 30 June 2014. Australian Prudential Regulation Authority (APRA) 2014, *Quarterly Superannuation Performance (interim edition)*, June ed., APRA, Sydney, page 8.

reduction would increase the accumulated balance at retirement for a male employee on average weekly ordinary-time earnings by around \$32,000, and provide up to approximately an extra \$2,000 per year in retirement income (in 2014 dollars).⁴⁵

Options considered

The Interim Report raised the first option below. The second option was raised in submissions and stakeholder discussions.

1. **Recommended:** Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have significantly improved competition and efficiency in the superannuation system.
2. Allow employers to choose any MySuper product as the default product for their employees and/or strengthen the MySuper licensing process.

Option costs and benefits

Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review determines it is not necessary

Under this option, each fund would be required to compete for new workforce entrants to be allocated to the fund's MySuper product, thereby building on the MySuper framework. Individuals would retain the right to exercise choice (see *Recommendation 12: Choice of fund*). Employers would no longer be required to select default funds for employees, and there would be generally no need to specify default funds in employment contracts, including awards.

This option would stimulate competition in the default fund market and extend the benefits of wholesale competition, which are currently only obtained by larger corporations and through awards, to the broader workforce. More of the benefits of scale would accrue to members, ensuring fee reductions do not come at the expense of lower net returns.

The benefits of this option would not be limited to new workforce entrants. As mentioned, successful funds would be required to provide the same product to their existing default members. Better outcomes in the default fund market would be expected to have flow-on effects to the non-default (or 'choice') market. Fees charged for default products provide a point of comparison against which more fee-sensitive consumers can assess choice products.

45 Modelling prepared for the Financial System Inquiry using Treasury models, October 2014. The models are based on a 30-year-old male worker in 2014 who retires at age 67.

Financial System Inquiry — Final report

A number of stakeholders support a process to foster competition. National Seniors Australia recommends "... the government further investigate auctioning management rights to default super funds as a way of fostering fee competition between super funds and, subject to a satisfactory auction design, commit to implementing this approach".⁴⁶ Other stakeholders believe the current level of competition between MySuper products is reasonable.

Existing members would retain their active fund when they change employment, without having to take action. Currently, in many cases, members have to consolidate accounts or exercise choice when they change employers to remain in their fund. This option addresses the main driver of account proliferation and would reduce the extent of workers paying fees and insurance in multiple accounts or losing superannuation accounts.⁴⁷ This could increase superannuation balances at retirement by around \$25,000 and retirement incomes by up to \$1,600 per year.⁴⁸

This option would remove the role of the industrial relations system in selecting default funds. This would reduce employers' compliance costs and address concerns, raised in several submissions, about superannuation funds offering employers inducements to choose the fund.⁴⁹ It would also better align incentives between employers and employees.

A potential downside of this option is less tailoring of life insurance policies and investment strategies to specific demographics of fund members; for example, if members work in the same industry. Some superannuation funds have been able to tailor insurance and other product features because of the homogeneous nature of their membership.

It is possible that the competitive process conducted by Government could create perceptions that Government is implicitly underwriting product performance of the

46 National Seniors Australia 2014, Second round submission to the Financial System Inquiry, page 5.

47 For example, as at 30 June 2014, there were six million lost superannuation accounts with a total value of just under \$16.8 billion. Australian Taxation Office (ATO) 2014, *Lost and ATO-held super overview*, ATO, viewed 27 October 2014, <<https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Lost-and-ATO-held-super/Lost-and-ATO-held-super-overview>>.

48 Modelling prepared for the Financial System Inquiry using Treasury models, October 2014. Based on assumptions of 37 years of work with an average of 2.5 accounts over a person's working life, fixed fees of \$80 per account and \$140 for insurance per account per annum (in 2014 dollars).

49 For example, see Association of Superannuation Funds Australia 2014, First round submission to the Financial System Inquiry, page 31; Australian Institute of Superannuation Trustees 2014, Second round submission to the Financial System Inquiry, page 35; and Equip 2014, Second round submission to the Financial System Inquiry, page 9.

successful funds. Government should continue to make it clear that it does not guarantee the performance of any fund, including those selected through any competitive process.

Stakeholders raise a number of concerns with how a competitive process would be designed. The Inquiry agrees with submissions' arguments that a competitive process would not be effective if it focused on fees alone. However, large corporates run competitive tenders and there is no evidence to suggest that these tenders in the wholesale market have either disadvantaged members or been unable to balance lower costs with asset allocation strategies that maximise returns to members. See the *Implementation considerations* section for a detailed discussion of potential design issues and how these could be overcome.

Superannuation system review by 2020

Funds and their members have incurred significant costs as the Stronger Super reforms have been implemented. Although the Inquiry has some reservations regarding the extent to which the reforms will increase superannuation system efficiency, it recognises the need for full implementation of MySuper to allow it the opportunity to work before embarking on further reform. The outcomes of these reforms should be reviewed after all accrued default amounts have been rolled into MySuper products in 2017, by which time MySuper products will have been in operation for at least four years. Submissions support such a review.

Allow all employers to choose any MySuper product as the default fund for their employees and/or strengthen the MySuper licensing process

The Inquiry considered two additional alternatives to the current arrangements.

The **first alternative** involves abolishing the new Fair Work Commission (FWC) process for selecting default funds in awards and allowing all MySuper products to be listed in awards. Under this alternative, employers could select any MySuper product to satisfy the requirements under an award.

A number of submissions support this option, arguing that present arrangements are costly to members, Government and industry, and duplicate APRA's MySuper licensing process. Some stakeholders are also concerned that the FWC selection process lacks transparency.

The Inquiry believes that this alternative would only be effective if there were an alternative quality filter for default fund selection. The PC's inquiry into default funds in awards found that a 'quality filter' is needed, stating: "The Stronger Super reforms serve largely to standardise features and promote disclosure to improve comparability between MySuper products, rather than filter out any products which may not

Financial System Inquiry — Final report

represent the best interests of employees”.⁵⁰ The PC made a number of recommendations to improve the effectiveness of this filter, which the Inquiry supports and which are still to be implemented by Government.

This option could also increase employers’ compliance costs, particularly new employers, by requiring them to select a fund from a large number of MySuper products that are not easily comparable. In its report, the PC quoted CPA Australia as saying, “To allow all MySuper products to be listed as default funds for a modern award would result in overwhelming choice making it difficult for [employers] to differentiate and make an informed choice in much the same way as if no funds were listed”.⁵¹

The **second alternative** involves strengthening the current requirements for MySuper products, which could be achieved by imposing stricter MySuper licensing requirements, including caps on fees. Fee caps could be effective in reducing fees, but would not necessarily improve returns net of fees and may lead to clustering of fees around caps. A stricter approach to regulating MySuper products would fundamentally change APRA’s role from authorisation to approval. It would increase the cost of the validation process for funds and risk APRA having to withdraw funds’ MySuper authorisation. This would have adverse implications for employers, who would have to choose another default product for their employees, and contribute to the proliferation of individuals with multiple accounts.

Conclusion

Introducing a formal competitive process has considerable merit and is likely to deliver substantial benefits to superannuation fund members. It would stimulate competition between funds on fees and returns to deliver better member outcomes. Although this is expected to generate further fund consolidation, the Inquiry does not have major concerns given the current high degree of fund fragmentation. The recommendation would build on the recent Stronger Super reforms and extend the benefits of wholesale competition to the broader default fund market.

Although industry would bear costs to participate in the competitive process, these costs are expected to be small relative to the benefits for members from reduced fees.

While considering the Stronger Super reforms to be a positive and significant step forward, the Inquiry has some reservations as to whether these reforms alone will significantly improve superannuation system competition and efficiency. Recognising

50 Productivity Commission 2012, *Default Superannuation Funds in Modern Awards: Productivity Commission Inquiry Report*, Commonwealth of Australia, Canberra, page 10.

51 Productivity Commission 2012, *Default Superannuation Funds in Modern Awards: Productivity Commission Inquiry Report*, Commonwealth of Australia, Canberra, page 171.

it is too early to evaluate their effectiveness, the Inquiry recommends a review of the superannuation system by 2020 before proceeding with further reform.

Implementation considerations

Review of the superannuation system by 2020

A PC inquiry into superannuation system efficiency and competitiveness should occur by 2020, after the MySuper implementation is complete in 2017. The inquiry should consider:

- The nature of competition in the superannuation default fund market, including how employers select default funds.
- Changes in fees and returns net of fees and taxes (including links to scale economies, asset allocation and/or type of investing) in both accumulation and retirement products.
- The distribution of fees for similar products.
- Flow-on effects to the choice market.

The PC inquiry should determine whether implementing a formal competitive process would deliver net benefits.

Design of the competitive process

Default funds for new members could be selected through a range of competitive processes, including auctions or tenders. New workforce entrants could be assigned to a MySuper product when they apply for a tax file number.

Designing a robust process will require careful thought and consultation. Without pre-empting the findings of its inquiry, the PC should begin preliminary work to design the competitive process. This work should commence from 2015 to provide the inquiry with a clear proposal against which to assess the benefits of further policy change.

In designing the competitive process, the merits of different approaches should be considered, as well as the associated metrics and frequency of running the competitive process using an evidence-based approach. This should include:

- Reviewing the strengths and weaknesses of competitive processes used in large corporate tenders, used by the Northern Territory Government and in other jurisdictions, such as Chile, New Zealand and Sweden.
- Quantifying the costs and benefits of different mechanisms.

Financial System Inquiry — Final report

- Assessing the incentives embedded in the scheme to evaluate its robustness to gaming and collusion.

Principles for designing the competitive process should include:⁵²

- **Best interests:** ensure incentive compatibility with meeting the best interests of members, encourage long-term investing, discourage excessive risk taking and encourage a focus on after-fee returns.
- **Competition:** drive pressure on funds to be innovative and efficient, diversify asset allocation and maximise long-term after-fee returns by rewarding best performers. Facilitate new superannuation fund entrants to the market.
- **Feasibility:** ensure the process is low-cost and easy to administer, and minimises regulatory costs on industry.
- **Credibility and transparency:** make relevant information public; avoid room for gaming the process; and ensure metrics are clear, simple, difficult to dispute and difficult to manipulate.
- **Regular assessment and accountability:** regularly conduct a repeat process that requires default funds to earn their right to receive new members, and ensure funds are accountable for the outcomes they deliver members.

Criteria for selecting the successful funds should focus on expected after-fee returns based on asset allocation and investment strategy, fees and past performance. This would help avoid fee reductions at the expense of member returns. Any other requirements deemed necessary could be included as pre-selection criteria to participate in the competitive process.

The Inquiry agrees with stakeholders that the formal competitive process also needs to be carefully designed and implemented (see *Table 4: Potential design issues of a competitive process*).

52 Drawn in part from the PC's recommended principles for designing a selection process: Productivity Commission 2012, *Default Superannuation Funds in Modern Awards: Productivity Commission Inquiry Report*, Commonwealth of Australia, Canberra, page 23.

Table 4: Potential design issues of a competitive process

Potential design issues or concerns	Response or design approach
A formal competitive process is unproven. Furthermore, governments have a poor track record of running formal competitive processes.	Large corporate funds successfully run tenders. A number of other jurisdictions use competitive tendering in pension funds; for example, New Zealand, Chile, and Sweden. Governments around Australia run successful tenders, including the Future Fund, and the Northern Territory Government for its public sector superannuation scheme.
The market disruption would be too great.	The effect on market structure could be gradual, as only new entrants to the workforce would be assigned to funds under the competitive process. By default, existing members would remain in their current fund, thereby minimising market disruption. Unsuccessful funds may have increased switching rates; however, current switching rates are very low. ⁵³ All funds can still compete for choice members.
A Chilean-style auction that selects a single or small number of successful bidders would inhibit competition and innovation, and lead to excessive market concentration.	A significant number of successful funds would be selected, which would drive competition and innovation. Some market consolidation is likely to occur, but excessive market concentration can be avoided if a sufficient number of funds are selected through the competitive process.
Fees should not be the sole focus. This would result in a 'race to the bottom' whereby funds change asset allocation and investment strategies to reduce fees.	The Inquiry agrees with this sentiment and considers a focus solely on fees is not in members' best interests. As discussed above, the focus should include expected ability to generate high after-fee returns based on asset allocation and investment strategy, as well as past performance.
How will the competitive process lower fund costs?	Competitive pressures will help to keep fund costs down as assets in the system continue to grow. Member acquisition costs will fall as funds do not need to compete for default fund members (outside the tender process). More consolidation of funds and reduced proliferation of multiple accounts across members will better realise the benefits of scale.
Focusing on the default fund market and only targeting new entrants to the workforce is too narrow-focused. It will not address competition and efficiency issues in the broader superannuation system.	Successful funds would be required to offer the same fees and MySuper products to all members (both new and existing). They could not price discriminate across the market. Outcomes in the default market represent a baseline against which choice products could be compared and could be expected to drive greater competition. Transfers to these funds would be facilitated by the recommendations to allow all employees choice of fund (discussed in this chapter) and increase member engagement (see <i>Appendix 1: Significant matters</i> for further detail).
A competitive process would lead to the loss of existing high-performing corporate funds.	Existing corporate funds could be allowed to continue to receive new default fund members from new entrants to the workforce provided the fund gives members comparable benefits to funds successful in the formal competitive process.

53 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 per cent to 5 per cent since 2005. Roy Morgan Research 2013, *Superannuation and Wealth Management in Australia Report*, December 2013, page 29.

Financial System Inquiry — Final report

Potential design issues or concerns	Response or design approach
Any competitive process can be gamed.	Careful design, rigorous execution and the highest standards of probity and expertise will be required. As mentioned above, other jurisdictions and corporations already run tenders successfully.
Past performance is not an accurate predictor of future performance.	Past performance would be only one element of the selection process when assessing expected ability to generate high after-fee returns to members.
What would stop unsuccessful funds significantly increasing their fees for existing default fund members?	Funds that do this could be disqualified from future competitive processes. Prompts on myGov for individuals to look at a central repository of MySuper dashboards would also help encourage members to engage with superannuation and transfer to the fund that best meets their needs (see <i>Appendix 1: Significant matters</i> for further details).
What if a successful high-performing fund underperforms?	Funds could lose the right to receive new members. Members would be advised if their fund was no longer deemed a successful fund.
A competitive process would impose costs on employers, who would have to make contributions to multiple funds.	While SuperStream will simplify how contributions are made, Government should consider implementing a national 'payment hub' or 'clearing house' by which employers make superannuation contributions to multiple funds. This concept has been implemented in other countries, including New Zealand and Sweden.

The retirement phase of superannuation

Recommendation 11

Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.

Description

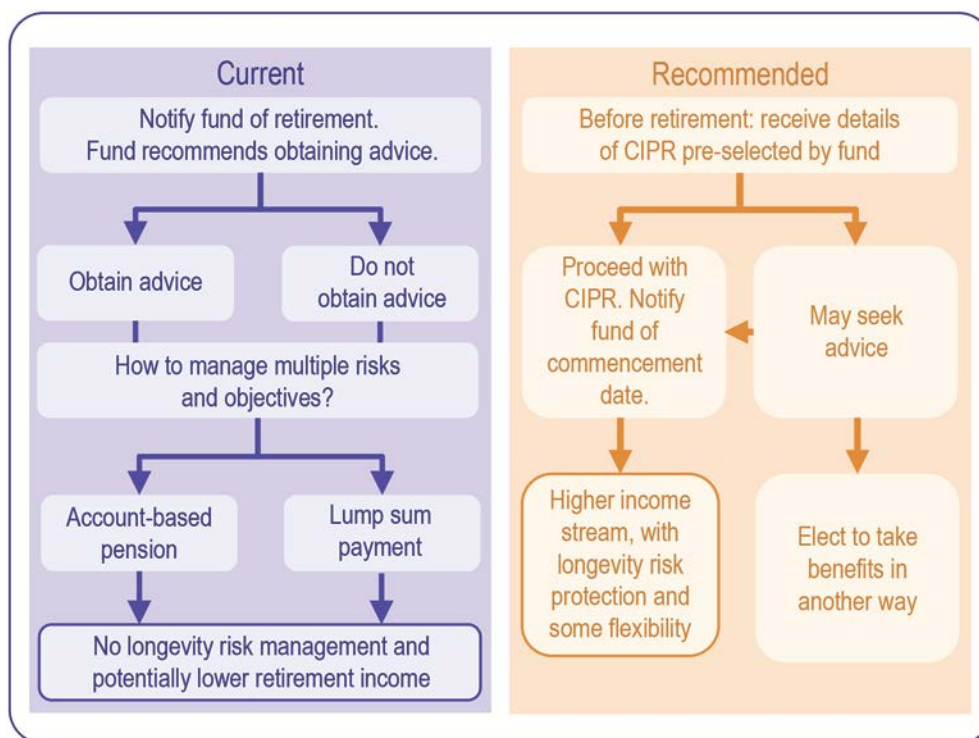
Government should require superannuation fund trustees to pre-select an option for members to receive their superannuation benefits in retirement. Details of the pre-selected option would be communicated to the member during their working life. At retirement, the member would either give their authority to commence the pre-selected option or elect to take their benefits in another way. This approach would simplify decisions at retirement and deliver better outcomes for retirees (*Figure 8: Stylised example of decision making for superannuation benefits*). No income stream would commence without the member's instruction.

The pre-selected option should be a comprehensive income product for retirement (CIPR) that has minimum features determined by Government. These features should include a regular and stable income stream, longevity risk management and flexibility. CIPRs would be low-cost and include a 'cooling off' period. Their design could vary with the member's known characteristics, such as the size of their superannuation benefits, and take account of the possibility of cognitive impairment at older ages.

A combination of underlying products would likely be required to provide these features; for example, an account-based pension paired with a pooled product that provides longevity risk protection. To offer these products, funds may need to partner with another provider, such as a life insurance company.

Regulatory impediments to developing retirement income products, which include tax policy settings, need to be removed. These changes should not discourage the use of CIPRs or other products that provide longevity risk protection.

Figure 8: Stylised example of decision making for superannuation benefits



Objectives

- Better meet the needs of retirees, including those who are disengaged or less financially sophisticated, and provide a more seamless transition to the retirement phase of superannuation.
- Achieve the objectives of the superannuation system (discussed earlier in this chapter) by strengthening the focus on providing retirement incomes.
- Improve Australians' standard of living during their working lives and retirement through greater risk pooling.

Discussion

Problems the recommendation seeks to address

Complex decisions

Managing multiple financial objectives and risks in retirement is complex. For example, retirees may seek to maximise income while trying to retain flexibility to meet unexpected expenses and manage longevity, investment and liquidity risks. Individuals have to manage these problems without the guidance that exists in the accumulation phase, where funds are required to offer simple, low-cost default

accounts. MySuper is an accumulation product only, despite the Super System Review recommendation that MySuper products include a retirement income stream.⁵⁴

Information from stakeholders suggests that many retirees find it challenging to navigate the transition to the retirement phase of superannuation. When DC members notify their superannuation fund of their retirement, many funds recommend they speak to an affiliated financial adviser. Research has demonstrated that the quality of this advice can vary significantly.⁵⁵ Anecdotal evidence suggests that some advisers have limited knowledge of longevity risk and how it can be managed.⁵⁶ Although the Inquiry makes recommendations to improve the quality of advice, it will take time for such improvements to occur. *Chapter 4: Consumer outcomes* explores this issue in further detail.

In any case, many people do not seek professional advice, and funds and advisers overwhelmingly recommend account-based pensions. Stakeholders advise that, for less financially literate individuals, the simplest option is to take the entire benefit as a lump sum because other options can be difficult to understand and may require completing complicated forms. A recent survey commissioned by AustralianSuper found that "... 85% of pre-retirees are not confident in having an informed conversation around retirement income".⁵⁷ Managing income and risks can be particularly difficult for people later in retirement if they suffer from cognitive impairment.

Behavioural biases

The complexity of retirement decisions is compounded by behavioural biases.⁵⁸ Mandatory superannuation contributions have been used to overcome behavioural biases in saving behaviour, such as decision making that disproportionately focuses on the short term; however, these biases do not end at retirement. In part, behavioural biases explain the dominance of account-based pensions and lump sums.

54 Commonwealth of Australia 2010, *Super System Review Final Report, Part Two: Recommendation Packages*, Chapter 7: Retirement, Recommendation 7.1, Canberra, page 207.

55 Shadow shopping research conducted by the Australian Securities and Investments Commission (ASIC) found that only 3 per cent of financial advice about retirement was "good quality". ASIC 2012, *Report 279: Shadow shopping study of retirement advice*, ASIC, Sydney, page 8. This study was conducted before the Future of Financial Advice reforms.

56 Longevity risk is not covered in the Australian Securities and Investments Commission's compulsory RG 146 qualifications for superannuation advisers. This could be improved by raising competency standards, as recommended in *Chapter 4: Consumer outcomes*.

57 AustralianSuper 2014, Data provided to Financial System Inquiry, 10 September 2014.

58 See Benartzi, S 2010, *Behavioral Finance and the Post-Retirement Crisis*, Allianz of America, USA, for a discussion of these biases.

Limited range of income stream products

Australians who wish to convert their superannuation assets into an income stream generally have the choice of an account-based pension or an annuity. A well-functioning market would be expected to provide a wider range of products that meet different needs and preferences. This would allow people to combine products to achieve their desired levels of income, risk management and flexibility. However, there are tax, regulatory and other impediments to developing innovative retirement income products.

Despite the heterogeneous nature of retirees, at least 94 per cent of pension assets are in account-based pensions, which provide flexibility but lack risk management features and may not deliver high levels of income from a given accumulated balance.^{59,60} The lack of a significant market for products with longevity risk protection sets Australia apart from most other developed economies.⁶¹ Evidence suggests that the major worry among retirees and pre-retirees is exhausting their assets in retirement.⁶² An individual with an account-based pension can reduce the risk of outliving their wealth by living more frugally in retirement and drawing down benefits at the minimum allowable rates.⁶³ This is what the majority of retirees with account-based pensions do, which reduces their standard of living.^{64,65} The difficulty in

59 Plan for Life 2014, Data provided to Financial System Inquiry, 23 June 2014.

60 A measure of income from a given accumulated balance, 'income efficiency' is the expected present value of income in retirement as a percentage of a product's purchase price. The income efficiency of a 65-year-old male's account-based pension, drawn down at minimum rates, is around 70 per cent. Australian Government Actuary, Data provided to Financial System Inquiry, 11 June 2014.

61 The size of Australia's annuity market is only around 0.3 per cent of gross domestic product, compared with 28.8 per cent in Japan, 15.4 per cent in the United States and more than 40 per cent in some European countries. Organisation for Economic Co-operation and Development 2013, 'Survey of annuity products and their guarantees', paper presented at the *Insurance and Private Pensions Committee meeting*, Paris, 5–6 December.

62 More than half of the respondents to a survey were either worried or extremely worried about outliving their savings. When asked to identify the single most important feature in a retirement income product, twice as many members identified "income that lasts a lifetime" as the second most popular response. Investment Trends 2013, *December 2013 Retirement Income Report*, Investment Trends, Sydney. Note: Based on a survey of 5,730 Australians aged 40 and older. Results from another 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. National Seniors Australia and Challenger 2013, *Retirees' needs and their (in)tolerance for risk*, National Seniors Australia, Brisbane, page 10.

63 The regulatory prescribed minimum rates range from 4 per cent for people aged 55 to 64, to 14 per cent for those over the age of 95.

64 Most retirees draw down their account-based pensions at the minimum allowable rates. 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, page 19.

managing this risk is also exacerbated by the uncertainty as to how long a retiree will live.⁶⁶

Rationale

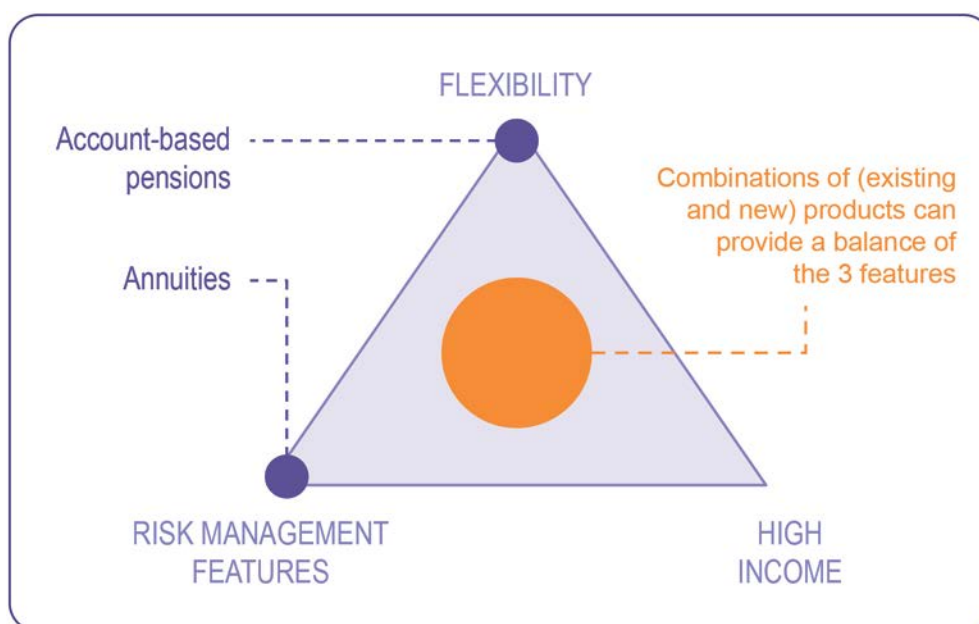
The potential gains to members, the economy and taxpayers from a more efficient retirement phase are significant and warrant intervention. Higher income in retirement and a wider range of retirement income products would better meet the varied needs of retirees. The economy will benefit if the growing proportion of people in retirement can sustain their level of consumption.

Combinations of products enable retirees to balance the three desired features of retirement income products: high income, risk management features and flexibility (*Figure 9: Desired features of retirement income products*). Pooling of longevity risk would give retirees greater confidence to consume. Alternatively, by improving the superannuation system's efficiency in providing retirement income, people may be able to save less during their working lives to reach a given level of retirement income.

65 Research suggests that these below-optimal rates result in lower welfare for individuals. Bateman, H and Thorp, S 2008, 'Choices and Constraints over Retirement Income Streams: Comparing Rules and Regulations', *Economic Record*, vol 84, pages S17-S31.

66 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. Even if individuals knew their life expectancy (which is generally not the case), the probability of a 65-year-old dying at a particular age is no greater than about 5 per cent. Commonwealth of Australia 2009, *Australian Life Tables 2005-07*, Canberra, using 25-year mortality improvement factors.

Figure 9: Desired features of retirement income products



Private provision of longevity risk protection could benefit taxpayers and the broader economy. It would shift some of the longevity risk borne by Government, as the provider of the Age Pension, to the private sector. Assets underlying products with longevity risk protection could be invested with a longer time horizon, helping to fund long-term investments and develop the corporate bond market in Australia as funds seek more investments that provide a steady flow of income.

Options considered

The Interim Report broadly identified four options that would enable the retirement phase to better achieve the objectives of the superannuation system and position Australia to manage the challenges of an ageing population:

1. **Recommended:** Require superannuation trustees to pre-select a CIPR for members.
2. **Recommended:** Remove impediments to retirement income product development.
3. Provide policy incentives that encourage retirees to purchase retirement income products that help manage longevity and other risks.
4. Mandate specific retirement income products (in full or in part, or for later stages of retirement).

Option costs and benefits

Require superannuation trustees to pre-select a CIPR for members

Under this option, superannuation fund trustees would be required to pre-select CIPRs for members to receive their superannuation benefits. Members would retain the freedom to take their benefits in another way if they desired. Appropriately designed pre-selected options would offer an effective, low-cost means of improving retirement income and risk management for superannuation fund members without limiting personal freedom and choice. This option would also help to develop markets for a wider range of income products with enhanced risk-management characteristics.

Greater use of products that pool longevity risk could significantly increase retirement incomes. For many retirees, incomes from CIPRs could be 15–30 per cent higher than those from the current typical strategy of drawing the minimum amount from an account-based pension.⁶⁷ The Inquiry notes that one of the primary reasons why incomes are significantly higher in products that pool longevity risk is that they reduce bequests from superannuation. Although the system should accommodate bequests, it should not do so to the detriment of retirement incomes.

Pre-selected options would simplify the process of using an accumulated balance to generate an income stream. The member guides that exist for the accumulation phase currently cease at retirement. Pre-selected options would bring the policy philosophy in the retirement phase closer to that of the accumulation phase.

People can benefit from pre-selected CIPRs in different ways. CIPRs can improve retirement incomes and risk management outcomes, especially for the disengaged and those who are less financially sophisticated, by providing a comprehensive option that balances a number of objectives and risks. The design of CIPRs can also guide more engaged members by providing a framework for decision making. Johnson and Goldstein (2013) suggest such an approach would be effective for three main reasons:⁶⁸

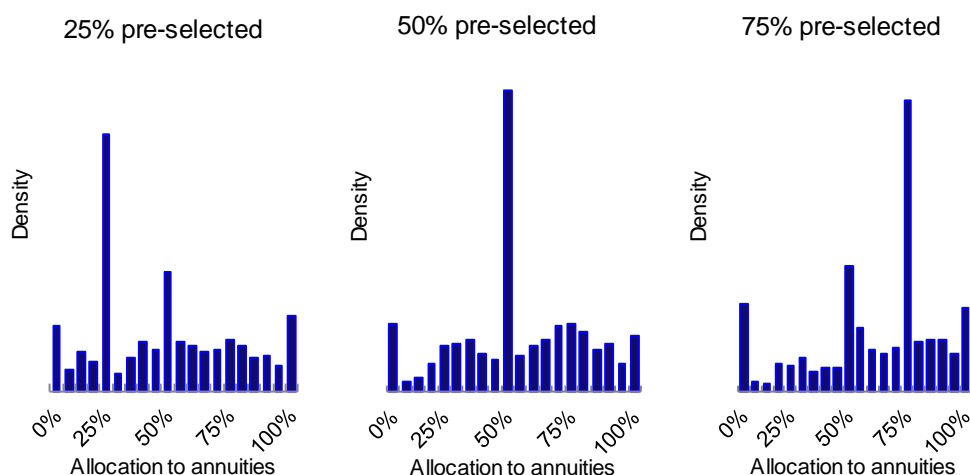
1. **Effort** – real or psychological costs of moving from the pre-selected option.
2. **Implied endorsement** – products are perceived to be recommended.
3. **Loss aversion and reference dependence** – decisions are affected by the starting point.

67 Australian Government Actuary modelling prepared for the Financial System Inquiry shows that CIPR examples 1, 2 and 3 described in the *Implementation considerations* section of this recommendation increase expected income in retirement by 14 per cent, 30 per cent and 31 per cent respectively, excluding income from the Age Pension. Australian Government Actuary, Data provided to Financial System Inquiry, 10 October 2014.

68 Johnson, E and Goldstein, D 2013, 'Decisions by default', in Shafir, E (ed.), *The Behavioral Foundations of Public Policy*, Princeton University Press, Princeton, pages 417–427.

Pre-selecting options can have a significant influence on decision making. This was shown in an Australian experiment that involved individuals allocating savings between account-based pensions and annuities. The study found that the distribution of allocations was strongly clustered around the pre-selected allocations (Chart 4).

Chart 4: Proportion of assets taken as an annuity with different pre-selected allocations



Source: Bateman et al.⁶⁹ This study referred to pre-selected options as defaults. The allocation to annuities was pre-selected for participants who were able to change the allocation as they desired.

Although designing CIPRs would be more complex than designing accumulation accounts, trustees are well placed to select appropriate CIPRs for their members, within a defined framework. ASFA argues "... trustees should exercise their fiduciary duty to consider longevity, market risk and inflation risk in designing post-retirement arrangements in much the same way they need to consider investment risk and insurance needs throughout the accumulation stage".⁷⁰ Funds would incur the costs of selecting, establishing and maintaining CIPRs, but these costs would be justified by the benefits to members.

However, CIPRs would be less beneficial to individuals with very high or very low superannuation balances. Those with small balances are likely to continue to take their benefit as a lump sum and rely primarily on income from the Age Pension. Individuals with very high balances may be able to generate satisfactory retirement income from an account-based pension, drawn down at minimum rates.

69 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*.

70 Association of Superannuation Funds of Australia 2014, Second round submission to the Financial System Inquiry, page 101.

A change in the way superannuation benefits are taken could affect Age Pension costs, as discussed in the *Implementation considerations* section later in this recommendation.

Remove product development impediments

As discussed in the Interim Report, regulatory and other policy impediments are hampering the development of retirement income products such as deferred lifetime annuities (DLAs) and group self-annuitisation (GSA) schemes.⁷¹ These impediments include rigid standards to qualify for earnings tax exemptions. The Inquiry supports the review of retirement income stream regulation being undertaken by Government, which is examining ways to reduce or remove barriers to developing a market for DLAs.

However, increasing the range of products alone will not be sufficient to improve outcomes for retirees significantly. Behavioural biases and other system incentives will continue to impede the widespread use of pooled longevity risk products, despite evidence that many individuals would be better off.⁷²

Provide policy incentives to encourage the use of retirement income products that manage longevity and other risks

Several submissions support using tax and Age Pension incentives to encourage take-up of income products with longevity risk protection. The Australian Institute of Superannuation Trustees (AIST) recommends "... policy incentives that encourage retirees to purchase retirement income products that help them deliver their optimal retirement experience".⁷³ In the past, favourable treatment of products with better risk management features by the Age Pension means test has been shown to increase their use.⁷⁴

Although policy incentives would be likely to increase the use of superannuation to generate retirement incomes, incentives generally increase the cost of the retirement

71 Deferred lifetime annuities are a form of lifetime annuity where the commencement of income payments is delayed for a set amount of time after purchase. In a GSA scheme, participants contribute funds to a pool that is invested in financial assets. Regular payments from the pool are made to surviving members. GSAs allow pool members to manage idiosyncratic longevity risk but do not completely eliminate the risks associated with increases in life expectancies across Australia. GSAs differ from a lifetime annuity by not providing a guaranteed income stream. Instead, the adjustments to payments over time are subject to investment performance, mortality assumptions and experience.

72 Benartzi, S, Previtro, A and Thaler, R 2011, 'Annuitization puzzles', *Journal of Economic Perspectives*, vol 25, no. 4, pages 143-164.

73 Australian Institute of Superannuation Trustees 2014, Second round submission to the Financial System Inquiry, page 43.

74 Sales of annuities fell significantly after both the reduction in the asset test exemption in 2004 and its abolition in 2007. Plan for Life 2014, Data provided to Financial System Inquiry, 28 March 2014.

income system to taxpayers. However, it is important that tax and Age Pension settings do not discourage people from using CIPRs.

Mandate specific retirement income products

Mandatory use of certain retirement income products would achieve effective risk pooling and ensure superannuation is used to provide income throughout retirement. It would also overcome issues with adverse selection in products with longevity risk protection.

Mandatory use of products that pool longevity risk could disadvantage groups with lower life expectancies.⁷⁵ This could be mitigated by pricing products to reflect the characteristics of members, including their life expectancy, although this would be complex and add costs.

People tend to have diverse needs in retirement, and no given product or combination of products will be appropriate for everyone. Many submissions caution that compulsory income streams could result in poor outcomes for some individuals and stifle innovation. Although this option could help achieve the objectives of the superannuation system, it would remove individuals' flexibility to tailor their retirement plans to suit their needs and is not consistent with the Inquiry's philosophy.

Conclusion

Pre-selected CIPRs and greater use of longevity risk pooling at retirement could significantly improve the superannuation system's efficiency in providing retirement incomes and better meet the needs of retirees.

In making this recommendation, the Inquiry sought to balance the desire to increase system efficiency in providing retirement incomes with a degree of individual freedom and choice. The Inquiry favours an approach that preserves freedom and choice. However, if introducing pre-selected CIPRs does not achieve the intended objectives of this recommendation, Government could consider forms of defaults that commence automatically on retirement. Tax and Age Pension incentives could also be used to better achieve the objectives of the superannuation system.

High-quality advice may be useful to some individuals to help them manage their financial affairs in retirement. *Chapter 4: Consumer outcomes* contains recommendations to improve the quality of financial advice.

⁷⁵ For a discussion of these issues, see Commonwealth of Australia 2010, *Australia's future tax system: Report to the Treasurer, Part Two, Detailed analysis*, vol 1 of 2, Canberra, page 122.

Implementation considerations

Developing CIPRs will take considerable time. This recommendation should be implemented with sufficient lead time to allow superannuation funds to design products or form partnerships with other providers.

As pre-selected CIPRs are expected to influence retirees' decisions, it is important they provide good outcomes for large numbers of members. This recommendation involves trustees potentially designing, advising on and delivering CIPRs. For these reasons, Government should establish a mechanism to ensure each CIPR provides the required features, which should be specified in regulation. Ongoing regulatory oversight will also be required. Meeting regulatory requirements should provide trustees with some protection against breaching their fiduciary obligations.

CIPRs should be offered as a pre-selected option to all members of APRA-regulated funds – not only to MySuper members. Decisions about retirement are more complex than most decisions made in the accumulation phase. Individuals who leave the default system are still likely to benefit from CIPRs. Self-managed superannuation fund trustees should not be required to design or offer CIPRs because the trustees are the fund's members.

Government would need to consider how the Age Pension means test applies to new income stream products. In principle, the means test should not discourage products that manage longevity risk, should aim to provide neutral treatment of products with longevity risk protection, and should not make it difficult for individuals to smooth their income and consumption over retirement. Without some amendments to the Age Pension means test, some CIPRs could increase the cost of the Age Pension to taxpayers.⁷⁶

Design of CIPRs

People have different needs in retirement and will value the three desired attributes of retirement products (income, risk management and flexibility) differently. CIPRs should deliver a balance of these attributes. As no single product has all these features, a CIPR is likely to be a combination of products. A working group convened for the Inquiry by the Actuaries Institute recommends "... a portfolio approach is likely to be more suitable than a single default product. A sensible default might include an account-based product and another product with longevity risk protection".⁷⁷

76 Under the principles of the current means test, products with longevity risk pooling tend to increase Age Pension costs in the early years of retirement (due to faster depletion of assets when the assets test is binding) and reduce costs in later years (because of higher income when the income test is binding).

77 Working group convened for the Financial System Inquiry by the Actuaries Institute 2014, *Retirement Income: options for managing Australia's longevity risk*, Sydney, page 1.

Financial System Inquiry — Final report

Superannuation funds may work with life insurance companies, other funds or other entities to provide CIPRs.

Many people will live for several decades after retirement. CIPRs should therefore provide exposure to growth assets to increase retirement income. Rice Warner advises that "... any investment period of 20 or more years requires a significant proportion of growth assets."⁷⁸ Using CIPRs will allow superannuation funds to take a longer-term investment perspective and reduce the need for retirees to worry about sequencing risk.

Although CIPRs may include a combination of products, members should still be able to transition smoothly from the accumulation phase to the retirement phase.⁷⁹ Cooling off periods coupled with the provision of a (diminishing) return of capital in the event of early death may be appropriate for some pooled products. These products could be purchased using either a one-off payment or a series of premiums.

CIPRs could vary with known characteristics of the member, including the size of their superannuation benefits. A trustee could decide to recommend lump sum benefits to members with balances below a certain (low) threshold.

Example CIPRs

Examples of CIPRs that would provide the required features are described in Table 5.

Table 5: Examples of comprehensive income products for retirement
Allocation to different products; per cent of accumulated balance⁸⁰

	Longevity product (a)	Allocation to longevity product	Draw-down of account-based pension	Allocation to account-based pension
CIPR 1	DLA	23%	Exhaust balance at age 85	77%
CIPR 2	Deferred GSA	17%	Exhaust balance at age 85	83%
CIPR 3	GSA	75%	Minimum rates	25%

(a) Deferred products commence payments at age 85.

78 Rice Warner 2014, Second round submission to the Financial System Inquiry, page 14.

79 For example, an income product provided by a life insurance company could be paired with an account-based pension in the same way accumulation accounts include life insurance.

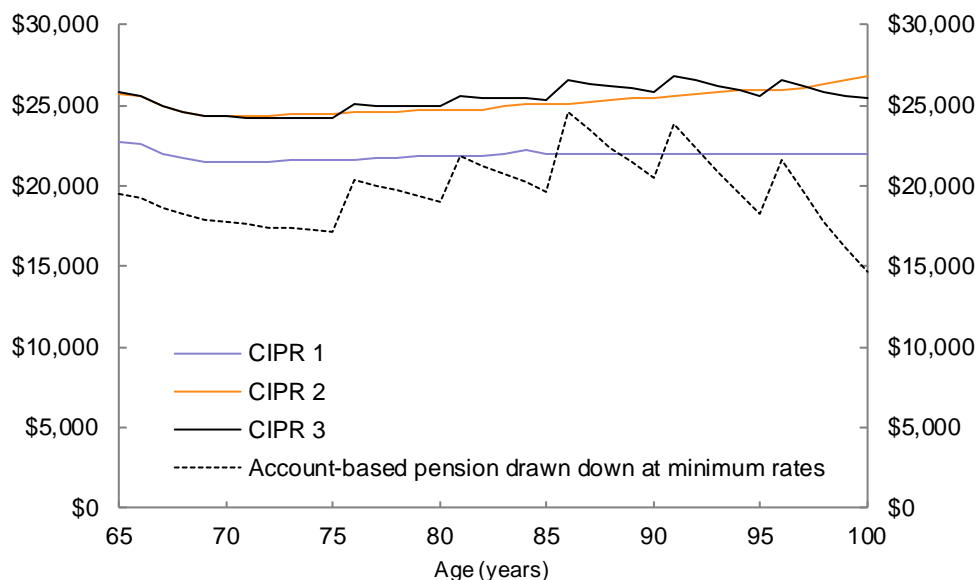
80 These allocations were designed to smooth retirement income from the CIPR (excluding the Age Pension). In practice, retirees would want to smooth total income, including the Age Pension. This would alter the proportion invested in deferred products. The current Age Pension means test makes it difficult to smooth total income.

The annual income expected to be generated by each of the above CIPRs for a male retiring at 65 years of age with a superannuation balance of \$400,000 (a typical balance in a mature superannuation system) is shown in *Chart 5: Expected annual income from example CIPRs*. The chart shows the amount of income he can expect to receive if he is still alive at each age. The income from an account-based pension drawn down at minimum rates – the most common strategy used by retirees at present – is included for comparison.⁸¹

The income streams represented in Chart 5 are only illustrative. They highlight the benefits of pooling and the ability to draw down an account-based pension faster without the retiree running the risk of outliving their wealth. The expected income from products is sensitive to assumptions regarding investment returns, draw-down rates and mortality.

Chart 5: Expected annual income from example CIPRs⁸²

For a 65-year-old male with a \$400,000 accumulated balance (excludes Age Pension)



Source: Australian Government Actuary modelling.⁸³

81 The full set of assumptions underlying these results and a sensitivity analysis are available in Australian Government Actuary 2014, *Towards more efficient retirement income products: Paper prepared for the Financial System Inquiry*, November 2014.

82 Produced using a stochastic model. The aim of achieving a relatively smooth income stream is affected by market and mortality variations.

83 Australian Government Actuary, Data provided to Financial System Inquiry, 10 October 2014.

Financial System Inquiry — Final report

Retirees using CIPRs would obtain significantly higher and smoother private retirement incomes while reducing the risk of outliving their savings (Chart 5 and Table 6). This is achieved through the loss of some flexibility and smaller bequests for some. As a portion of each CIPR is invested in an account-based pension, individuals retain some flexibility.

Table 6: Expected net present value of income from example CIPRs

For a 65-year-old male with a \$400,000 accumulated balance (excludes Age Pension)

	Expected income throughout retirement (NPV) ⁸⁴	Increase over account-based pension ⁸⁵	Increase over account-based pension (%)
Account-based pension drawn down at minimum rates	\$275,000	–	–
CIPR 1 ⁸⁶	\$314,000	\$40,000	14
CIPR 2	\$357,000	\$82,000	30
CIPR 3	\$359,000	\$85,000	31

Source: Australian Government Actuary modelling.⁸⁷

84 Net present value, rounded to the nearest \$1,000. Includes retirement income only (not bequests).

85 Rounded to the nearest \$1,000.

86 A similar increase in retirement income could be achieved with a combination of two thirds of assets in an account based pension drawn down at minimum rates and one third of assets used to purchase a GSA.

87 Australian Government Actuary, Data provided to Financial System Inquiry, 10 October 2014.

Choice of fund

Recommendation 12

Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.

Description

Government should remove provisions in the *Superannuation Guarantee (Administration) Act 1992* that deny some employees the ability to choose the fund that receives their SG contributions due to the exclusions given to enterprise agreements, workplace determinations and some awards.^{88,89}

Objective

- Remove barriers to members engaging with their superannuation by ensuring all employees, to the extent possible, have the right to choose their superannuation fund.

Discussion

Problem the recommendation seeks to address

A significant minority of employees cannot choose the superannuation fund that receives their SG contributions. In particular, this affects employees with a superannuation fund nominated in an enterprise agreement, a workplace determination or a state-based award. A 2010 ASFA paper found that around 20 per cent of employees cannot choose their fund.⁹⁰ These exemptions contribute to employees having multiple superannuation accounts and paying multiple sets of fees and insurance premiums, which reduces retirement income. (See the *Recommendation 10: Improving efficiency during accumulation* for further discussion on the cost of multiple accounts.) For some individuals, lack of choice contributes to disengagement with superannuation.

88 *Superannuation Guarantee (Administration) Act 1992*, Part 3A, s32C.

89 In principle, this recommendation should apply to all employees but, for Constitutional reasons, the Commonwealth cannot instruct changes to state agreements and awards.

90 Clare, R 2010, 'Choosing to choose', Association of Superannuation Funds of Australia, paper presented at the 18th Annual Colloquium of Superannuation Researchers, Sydney, 12-13 July, page 9.

Financial System Inquiry — Final report

When legislation was introduced to allow employees to choose their superannuation fund, concerns were raised about the compliance costs to employers from having to make contributions to multiple funds. However, changes in technology and the introduction of SuperStream are reducing these costs. Many employers use clearing houses to make payments to multiple superannuation funds, and Government already provides a free clearing house service for small businesses.

Submissions note that choice contributes to higher superannuation fees in Australia relative to some other countries. However, extending choice to the remaining 20 per cent of employees is not expected to increase costs significantly for industry.

Conclusion

As a general principle, the Inquiry believes everyone should be able choose the fund that receives their SG contributions. The superannuation system should assist members to achieve their individual goals and make savings decisions that suit their personal circumstances. Several submissions highlight the benefits of choice in providing flexibility for members and lowering fees through greater competition.

Accordingly, regulatory impediments to individuals exercising choice should be removed. State governments should be encouraged to allow all employees choice.

Governance of superannuation funds

Recommendation 13

Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.

Description

Government should amend the *Superannuation Industry (Supervision) Act 1993* to mandate that public offer APRA-regulated superannuation funds have a majority of independent directors on their trustee boards. The chair should also be independent. An arm's length definition of independence should apply.

Government should introduce civil and criminal penalties for directors who fail to execute their responsibility to act in the best interests of members, or who use their position to further their or others' interests to the detriment of members.

To ensure effective arrangements for dealing with conflicts of interest, each director's interests should be deemed to have been disclosed only when they have been acknowledged by all other directors.

Objectives

- Improve the governance of public offer superannuation funds, thereby protecting the best interests of members.
- Align the governance requirements and penalty regime for superannuation directors with those applying to directors of responsible entities of MISs.

Discussion

Problem the recommendation seeks to address

Although there is little empirical evidence about the relationship between quality of governance in Australian superannuation funds and their performance, high-quality governance is essential to organisational performance. Some overseas research suggests that good governance adds one percentage point to pension fund returns.⁹¹ The governance framework for Australian superannuation funds has shortcomings

91 Ambachtsheer, K 2007, *Pension Revolution: A Solution to the Pensions Crisis*, John Wiley & Sons, Hoboken, page 130.

Financial System Inquiry — Final report

that are inconsistent with good governance principles and, in the Inquiry's view, need to be addressed.

Including independent directors on boards is consistent with international best practice on corporate governance. Independent directors improve decision making by bringing an objective perspective to issues the board considers. They also hold other directors accountable for their conduct, particularly in relation to conflicts of interest.⁹²

At present, independent directors are not required on the boards of public offer superannuation entities. Some superannuation trustee boards have independent directors but others do not. A recent survey by Mercer found that 11 out of 19 funds without independent directors would not make changes to their board structure. Of the remaining eight funds, five said they would only appoint independent directors if it were mandated.⁹³

APRA recently issued prudential standards to improve the governance of superannuation trustee boards and the way in which these boards prevent conflicts of interest from influencing decisions.⁹⁴ However, structural requirements for the superannuation trustee boards are not aligned to other entities that manage funds on behalf of others, such as MISs. MISs must have either a majority of independent directors on the board of the responsible entity of the scheme, or a majority of independent members on their compliance committees.⁹⁵ The requirements for superannuation funds are also inconsistent with governance requirements for many of the entities they invest in, even though governance theory suggests that these requirements should be aligned.⁹⁶ Under the ASX Corporate Governance Principles, entities listed on the Australian Securities Exchange (ASX) are required to have a majority of independent directors on an "if not, why not" basis.⁹⁷

The Super System Review recommended that at least one-third of board members should be independent on those boards with equal representation (with the remainder of positions equally split between employer and employee representatives), and a

92 Organisation for Economic Co-operation and Development (OECD) 2004, *OECD Principles of Corporate Governance*, OECD, Paris, pages 64–65.

93 Mercer 2014, Super funds under-prepared for independent directors and increasing scrutiny, media release, 22 July, Melbourne, viewed 7 November 2014, <<http://www.mercer.com.au/newsroom/2014-superannuation-governance-survey.html>>.

94 Australian Prudential Regulation Authority (APRA) 2012, *Prudential Standard SPS 510: Governance*, APRA, Sydney; APRA 2013, *Prudential Standard SPS 521: Conflicts of Interest*, APRA, Sydney.

95 *Corporations Act 2001*, s601JA and s601JB.

96 Ambachtsheer, K 2007, *Pension Revolution: A Solution to the Pensions Crisis*, John Wiley & Sons, Hoboken, page 41.

97 ASX Corporate Governance Council 2014, *Corporate Governance Principles and Recommendations: 3rd Edition*, Recommendation 2.4, ASX Corporate Governance Council, Sydney, page 17.

majority should be independent on all other boards.⁹⁸ This would improve the current standards, but if independent directors are to have an effective influence on board decisions, all superannuation funds need a majority of independent directors.

In defined benefit schemes sponsored by a single employer, equal representation of employees and employers is appropriate and consistent with the governance models of defined benefit pension funds internationally. These funds would continue to operate using the structure for which equal representation was designed, with the employer bearing the financial risk from the board's decisions.

The equal representation model has less relevance in the current superannuation system, which predominantly consists of public offer DC funds and funds less focused on a single employer. As more fund members exercise choice, directors appointed by employer and employee groups are less likely to represent the broader membership of public offer funds (see *Recommendation 12: Choice of fund*). Given the diversity of fund membership, it is more important for directors to be independent, skilled and accountable than representative.

As part of Government's recent consultation process on reforms to superannuation fund governance, some stakeholders argued against mandating independent directors on superannuation boards.⁹⁹ The main arguments opposing the proposal were that appointing independent directors should be at the discretion of the fund based on its particular circumstances and needs, and that those funds using the equal representation model have generated higher returns than other funds in recent years. However, there is no evidence to suggest that the performance of these funds is driven by their equal representation model.

At present, superannuation directors are not subject to criminal or civil penalties in relation to their duty to act in the best interests of members. A member who has incurred loss or damage as a result of director misconduct can seek recovery through civil action – or APRA can disqualify the director. This is inconsistent with the regime applying to the directors of responsible entities of MISs under the *Corporations Act 2001*, who are subject to criminal and civil penalties.¹⁰⁰ The absence of criminal and civil penalties in relation to misconduct by superannuation directors represents a significant gap in the current framework.

98 Commonwealth of Australia 2010, *Super System Review Final Report, Part Two: Recommendation Packages*, Recommendation 2.7, Canberra, page 56.

99 For example, the submission by Industry Super Australia suggests placing a positive obligation on funds to consider making up to one-third of the directors on their board independent directors. Industry Super Australia 2014, *In members' best interests: ISA submission to Government discussion paper*, Industry Super Australia, Sydney, page 12.

100 *Corporations Act 2001*, s601FD and Part 2D.1.

Financial System Inquiry — Final report

APRA Prudential Standard SPS 521 includes a requirement to maintain a register of director interests. Although these requirements are broadly appropriate, conflict of interest requirements need to be particularly strong for superannuation funds because there is a trustee relationship between the fund and members, and most members are required by law to participate in the superannuation system. The requirements could be strengthened by specifying that each board member must acknowledge when a director adds an interest to the register. This would focus the attention of the board on director interests and ensure a rigorous oversight process.

Some submissions are concerned that this requirement would expand boards and increase costs to members. If superannuation fund boards expand to accommodate more independent directors, boards should justify to their members and APRA why such an expansion is required for the fund's proper governance and operation.

The need to strengthen superannuation funds' governance is particularly important given that members lack the power to remove directors who breach their duties. In MISs, unit-holders typically do not have rights to appoint or remove directors, but they do have the right to vote to replace the responsible entity managing their funds. Members in superannuation funds have no rights in this regard.

Conclusion

Requiring a majority of independent directors, with an independent chair, would strengthen the governance of superannuation funds. The Inquiry is not convinced by arguments that independent directors would have a negative effect on superannuation returns.

Strengthening disclosure arrangements and introducing civil and criminal penalties for director misconduct would increase the incentive for all directors to act in the best interests of superannuation fund members.

The Inquiry notes that directors of life insurance companies are not subject to civil and criminal penalties for breaching their duties to policy holders. Government should consider whether there is a case for also aligning the penalties applying to life insurance directors with those applying to MIS directors.

Taxation of superannuation

Observation

In reviewing the taxation of contributions and investment earnings in superannuation, the Tax White Paper should consider:

- Aligning the earnings tax rate across the accumulation and retirement phases.
- Options to better target superannuation tax concessions to the objectives of the superannuation system.

Objectives

- Remove tax barriers to enable a more seamless transition to retirement.
- Better target superannuation tax concessions to achieve the objectives of the superannuation system discussed earlier in this chapter and, in doing so, reduce the cost of the superannuation system to Government, reduce distortions to the allocation of funding in the economy, and improve long-term confidence and policy stability in the superannuation system.

Discussion

Problem the observation seeks to address

As acknowledged in submissions, superannuation is seen as an attractive savings and wealth management vehicle for middle- and higher-income earners due to the highly concessional tax treatment of contributions and earnings (*Chart 6: Share of total superannuation tax concessions by income decile*). According to Rice Warner, “It is self-evident that the tax concessions for superannuation are tilted towards those Australians who have the most income and wealth, and who have the highest personal marginal tax rates”.¹⁰¹

Superannuation tax concessions are not well targeted at the objectives of the superannuation system discussed earlier in this chapter. As illustrated in Figure 4.3 of the Interim Report, a small minority of members hold a high proportion of superannuation assets.¹⁰² Individuals with very large superannuation balances are able to benefit from tax concessions on funds that are likely to be used for purposes other than providing retirement income, such as tax-effective wealth management and estate

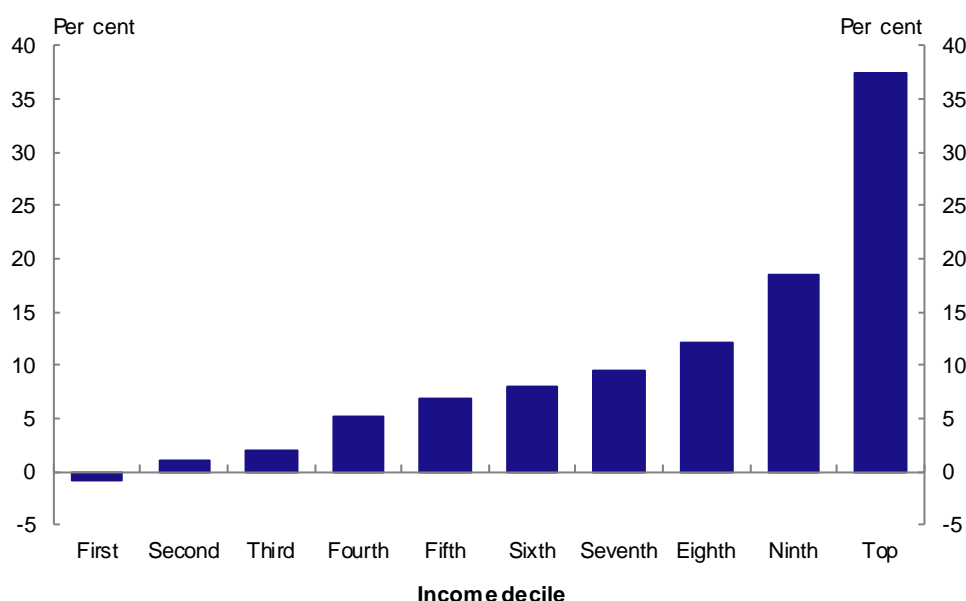
101 Rice Warner 2014, Second round submission to the Financial System Inquiry, page 24.

102 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-121.

planning.¹⁰³ The AIST supports “... a focus on promoting and delivering greater equity in the system to build retirement incomes over the course of every person’s working life, as opposed to making superannuation a tax effective wealth creation vehicle and estate planning tool, for the few”.¹⁰⁴

As a result, the majority of tax concessions accrue to the top 20 per cent of income earners (Chart 6). These tax concessions are unlikely to reduce future Age Pension expenditure significantly.¹⁰⁵

Chart 6: Share of total superannuation tax concessions by income decile



Source: Treasury, based on an analysis of 2011–12 Australian Taxation Office data.¹⁰⁶

Poorly targeted tax concessions increase the cost of the superannuation system to Government. In turn, this increases the fiscal pressures on Government from an ageing population. Giving high-income individuals larger concessions than are required to achieve the objectives of the system also increases the inefficiencies that arise from

103 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-126.

104 Australian Institute of Superannuation Trustees 2014, Second round submission to the Financial System Inquiry, page 5.

105 As noted in the Interim Report, “... the large number of accounts with assets in excess of \$5 million could each receive annual tax concessions more than five times larger than the single Age Pension”. Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-120.

106 Treasury 2014, Data provided to the Financial System Inquiry, 29 October 2014.

higher taxation elsewhere in the economy, including differences in the tax treatment of savings (refer to the *Appendix 2: Tax summary*).

In addition, tax concessions contribute significantly to policy instability and undermine long-term confidence in the superannuation system. Around half of the announced policy changes over the past 10 years appear to have been aimed at addressing concerns related to the targeting and equity of tax concessions.¹⁰⁷ Despite this, concerns remain and continue to undermine public confidence in the fairness and sustainability of policy settings.

The differential tax rates on earnings between the accumulation phase (taxed at 15 per cent) and the retirement phase (tax-free) of superannuation have adverse effects as they:

- Create a tax boundary that limits pension product innovation and acts as a barrier to funds offering whole-of-life superannuation products. This increases costs in the superannuation system by requiring multiple, separate accounts between the accumulation and retirement phases.¹⁰⁸
- Can contribute to sub-optimal investment strategies in the years approaching members' retirement by focusing attention on investing until the point of retirement (the end of the accumulation phase), rather than investing over the long term beyond the point of retirement.
- Provide an opportunity for tax arbitrage in superannuation between the accumulation and retirement phases. Capturing these benefits by allocating specific assets to individuals can result in a shift away from investment pooling and diversification in superannuation and reduce the efficiency of the system. It can also provide non-neutral outcomes between different types of funds, as mentioned in the Interim Report.

107 Financial System Inquiry analysis of Government policy announcements in annual Budget documents, Mid-Year Economic and Fiscal Outlook statements, Pre-Election Fiscal Outlooks and Economic Statements.

108 For example, if a retiree has commenced a pension and later decides to make a contribution to superannuation, the retiree will need to open a new accumulation account and a new pension superannuation account. This results in some members having multiple pension accounts in retirement.

Options considered

Align the earnings tax rate between the accumulation and retirement phases

As noted in some submissions, aligning the earnings tax rate between the accumulation and retirement phases would result in significant simplification benefits. This was also recommended by Australia's Future Tax System Review (AFTS).¹⁰⁹

Aligning the earnings tax rate could be revenue-neutral for Government, would reduce costs for funds, would help to foster innovation in whole-of-life superannuation products, would facilitate a seamless transition to retirement and would reduce opportunities for tax arbitrage. However, a positive tax rate in retirement could reduce equity for some lower-income individuals taking income streams.

Better target tax concessions

The Inquiry considered two options to better target superannuation tax concessions at achieving the objectives of the system. Both options would limit tax concessions for individuals with large superannuation balances.

1. Reduce the non-concessional contribution cap and better target superannuation contribution tax concessions

Some submissions suggest applying a more neutral tax treatment of superannuation across taxpayers. This could be done by implementing the AFTS recommendation to tax superannuation contributions at marginal rates less a flat-rate rebate.

Tightening the non-concessional contribution cap — currently \$540,000 over three years — would help to target the tax concessions for superannuation contributions better by reducing the extent to which individuals could accrue very large balances in the system in the future. The administrative and compliance costs would be relatively low. However, it would reduce individuals' flexibility to save for their retirement at different times of their life and could adversely affect individuals with broken work patterns.

109 AFTS made a number of recommendations regarding the taxation of savings and superannuation. AFTS recommended taxing long-term savings (including superannuation) at a lower rate to avoid discriminating against individuals who choose to defer consumption and save. It also recommended implementing a more neutral tax treatment of superannuation contributions across taxpayers. This Inquiry endorses these recommendations. Commonwealth of Australia 2010, *Australia's future tax system: Report to the Treasurer*, Canberra.

2. Levy additional earnings tax on superannuation account balances above a certain limit

This option imposes a higher rate of earnings tax on individuals with superannuation balances in excess of a certain limit. It would target superannuation tax concessions to achieve the objectives of the system and reduce costs to taxpayers. It would also facilitate the removal of the non-concessional contribution cap.

The Inquiry is aware that similar policy proposals in the past have not succeeded due to their complexity and the high costs of implementation.¹¹⁰ Industry express a strong view that imposing a different rate of earnings tax inside a pooled superannuation trust based on members' individual incomes would impose high compliance costs and complexity on funds. Submissions also stress the need to avoid options that impose large compliance costs on funds.¹¹¹

To avoid these large compliance costs, stakeholders raise alternative implementation options to which the Inquiry is attracted. One approach is to apply the higher rate of earnings tax to affected individuals outside the superannuation system, with the option of paying the tax liability out of superannuation benefits – similar to the mechanism for applying the tax on excess contributions. To reduce complexity further, the tax could be calculated on a simplified tax base.¹¹² This option would increase Government revenue.¹¹³

Conclusion

Superannuation taxation arrangements should be reformed to place policy settings on a more sustainable footing over the long term. Superannuation tax arrangements should be targeted to achieve the objectives of the superannuation system, reduce the cost of the retirement income system to Government, better position Australia to meet

110 The previous Government proposed capping earnings tax concessions in retirement at \$100,000 before a higher rate of tax would apply. The proposal was not implemented. In addition, the high costs of administration resulted in the abolition of reasonable benefit limits in 2007.

111 For example, see Mercer 2014, Second round submission to the Financial System Inquiry, page 32; Association of Superannuation Funds of Australia 2014, Second round submission to the Financial System Inquiry, page 57.

112 For example, the Australian Taxation Office could calculate superannuation earnings net of taxes and fees using existing account balance and contribution data, without the need for additional reporting. A less attractive alternative is to deem a rate of earnings on account balances based on industry-wide average returns, or based on long-run average returns. This could be justified on the basis of being a penalty rate of tax that seeks to discourage higher balances. The account balance limit could only apply in the retirement phase, if that further reduced implementation costs.

113 The increase in Government revenue in the short term would be reduced by implementation costs for the Australian Taxation Office.

Financial System Inquiry — Final report

the fiscal challenges of an ageing population and reduce funding distortions in the economy.

The choice between options to better target superannuation tax concessions rests partly on the treatment of very large superannuation balances already in the system, which are likely to be used for purposes other than providing retirement incomes. Tighter contribution limits could reduce the future prevalence of very large superannuation balances. On the other hand, account balance limits would address the disproportionate allocation of tax concessions to individuals with very large balances now and in the future, and reduce the costs of these concessions.

The Inquiry has not recommended a specific option because a range of relevant considerations fall outside its scope – in particular, interactions and alignment with the broader taxation system.

Implementation considerations

Prior to implementation, Government should consult with industry to avoid unintended consequences for industry and fund members.

Individuals have made superannuation contributions and decisions based on the existing rules and tax arrangements. If Government introduces a higher rate of earnings tax for account balances above a certain limit, transitional arrangements should be considered. For example, individuals with account balances above the limit could be given the opportunity to transfer assets out of the superannuation system without detriment.

Chapter 3: Innovation

The arrival of digital technology – the synthesis of computing and communications technology – marks the advent of one of the most ubiquitous generally applicable technologies the world has ever seen. Its impact has been, and continues to be, revolutionary for most industries, altering business operations and resulting in major productivity gains.

For the financial system, technology-driven innovation is transformative. New business models, products and services are emerging, driving competition and changing the way users interact with the system. Opportunities for innovation are abundant as, fundamentally, the sector revolves around recording, analysing and interpreting transactions and managing associated information flows. With no physical products to manage, these processes readily lend themselves to improvements via digital technologies. Consequently, the sector has already invested significantly in a range of technologies, leading to:

- **Increased self-service.** The introduction of the ATM represented a major first step towards self-service. More recently, it has been followed by online banking and insurance products, and the growth of comparator sites.
- **Evolving infrastructure and delivery models.** Cloud computing, real-time online ‘chat’ services and mobile payments platforms are changing the physical infrastructure used in financial services’ operations and delivery.
- **Alternative business models.** Technology is facilitating the disintermediation of traditional institutions, attracting many new entrants and non-traditional businesses. New technology-enabled mechanisms for accessing finance and obtaining credit are emerging in the Australian market, such as crowdfunding and peer-to-peer lending.
- **Fast, frictionless payments.** Electronic payments are growing in volume and progressing towards real-time funds transfers. Friction is diminishing with contactless terminals and the growing use of biometrics for payment authorisation. Some consumers are also accessing alternative mediums of exchange, such as digital currencies.
- **Increased use of data.** The financial sector’s ability to capture, store and analyse vast amounts of data enables firms to customise products for consumers, more finely segment customer groups and sharpen targeting of marketing initiatives. It is also improving risk modelling, risk-based pricing and research.

Financial System Inquiry — Final report

- **Increased potential for international integration and dependency.** Users and intermediaries can access international products, services and markets more easily, and foreign players have more opportunities to enter and compete in local markets.

As observed in the Interim Report, the disruptive effects of innovation have the potential to deliver significant efficiency benefits and improve user outcomes, notwithstanding costs associated with adjustment for industry, and possible uncertainty for some consumers about change.

As technology continues to increase network speeds, broaden distribution networks and heighten levels of interconnectivity, these changes can also amplify the risks of innovation across the system. The pace of technology-driven market developments can challenge regulatory frameworks and make it difficult for regulators to adapt with sufficient speed. Failure to manage these risks may result in system-wide impacts and/or adverse consumer outcomes.

Recommended actions

The Inquiry believes the innovative potential of Australia's financial system and broader economy can be galvanised by taking action to ensure policy settings facilitate future innovation that benefits consumers, businesses and government. Specifically, the Inquiry believes action can be taken in the following areas:

- **Industry and government can work together to identify innovation opportunities and emerging network benefits.** Where competitive forces prevent these opportunities from being fully realised, government should facilitate industry coordination. The Inquiry recommends establishing a permanent public-private sector collaborative committee to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.

Digital identity is a significant current example of an area where network benefits can be harnessed more effectively through public-private sector collaboration, and Government facilitating industry action. The Inquiry recommends developing a national strategy for a federated-style model of trusted digital identities in which public and private sector identity providers would compete to supply trusted digital identities, enhancing consumer choice, privacy, innovation and system efficiency.

- **Government and regulators can remove unnecessary impediments to innovation.** The Wallis Inquiry advocated functional frameworks to ensure risks emanating from similar economic functions are regulated in the same way and to provide entities performing the same function with competitive neutrality. This Inquiry believes graduating such functional frameworks can reduce barriers to innovation, while ensuring regulation is broadly risk-based. Graduation involves providing

lower-intensity regulation for new entrants that pose smaller risks to the system — that is, it targets regulation to where it is most needed in the system.

A dynamic and efficient payments system is an important component of the broader financial system as it underpins most transactions in the economy. At present, payments regulation is complex and fragmented. Developing clearly graduated functional regulation would facilitate innovation in the payments system. The Inquiry recommends mandating the ePayments Code, narrowing the scope of the Australian Financial Services Licence (AFSL) regime, and introducing a new two-tier framework for prudential regulation of purchased payment facilities. The Inquiry also recommends broadening the application of interchange fee caps across payment systems (including companion card systems) and proposes lowering current caps. Significant changes are recommended to the current rules on customer surcharging by merchants to allow system providers to ban customer surcharging for low-cost payment methods and apply fixed limits for medium-cost payment methods. Only higher-cost system providers would remain subject to the current arrangements.

Further graduating the regulation of market-based financing could improve the financial system's efficiency in funding future growth. Amending restrictive regulation that prevents small firms from seeking financing online from the general public could facilitate innovation in this area. The Inquiry recommends facilitating crowdfunding by adjusting fundraising and lending regulation, streamlining issuers' disclosure requirements and allowing retail investors to participate in this new market with protections such as caps on investment.

Amending unnecessarily technology-specific regulation and removing superfluous regulation can facilitate innovation. Technology-specific regulation can impede innovation by preventing the adoption of best technology or innovative approaches. For example, regulation may entrench the use of cheques or paper-based disclosure documentation, creating inefficient outcomes. See *Recommendation 39: Technology neutrality*.

- **Government and regulators can support data-driven business models.** As increasing amounts of data are collected and more sophisticated analytical techniques emerge, data can be used to develop alternative business models, products and services that improve consumer outcomes and system efficiency. These innovations can be facilitated by increasing access to de-identified and aggregated public sector data, improving consumers' access to their personal information, and enabling access to private sector data where this does not reduce incentives to collect the data. These processes could be aided by developing standards for accessing and formatting data, including product information, and addressing consumer privacy concerns to strengthen confidence and trust in the use of data. The Inquiry recommends Government commission the Productivity Commission to hold an inquiry into the costs and benefits of increasing access to and improving the use of data, subject to privacy considerations.

- **Regulators need flexibility to respond to future developments.** As market developments occur, regulators need to balance the benefits and risks of innovation and take a system-wide view. Regulators need appropriate frameworks, skills, capabilities and powers to manage emerging risks. Regulators should also have appropriate accountability mechanisms to assess the impacts of their policies on competition, innovation and efficiency. These mechanisms are discussed in *Chapter 5: Regulatory system*.

Principles

The Inquiry believes policy settings should facilitate innovation and market developments where these improve system efficiency and consumer outcomes. In making the following recommendations, the Inquiry has been guided by these principles:

- Industry and government should work together to identify innovation opportunities and emerging network benefits. Government should facilitate industry coordination where competitive forces prevent these opportunities from being fully realised.
- Regulation should be functional to ensure competitive neutrality and facilitate innovative business models. Regulation should also be graduated to enable market entry and ensure regulation is targeted to where it is most needed. At times, this may increase risks for some consumers, but it is expected to improve consumer outcomes overall.
- Regulation should aim to be technology neutral in design. Regulation should only be technology specific where selecting a common standard would improve overall system efficiency. Review mechanisms are needed to ensure technology-specific regulation does not become an impediment to innovation over time.
- Policy settings should aim to reduce information asymmetries by improving access to public and private sector data, subject to appropriate privacy safeguards to preserve consumer confidence and trust in the system, and maintaining private sector incentives to collect data.

Conclusion

The Inquiry believes implementing the package of recommendations in this chapter, and continuing to develop policy based on these principles, will contribute to developing a dynamic, competitive, growth-oriented and forward-looking financial system for Australia.

Collaboration to enable innovation

Recommendation 14

Establish a permanent public-private sector collaborative committee, the 'Innovation Collaboration', to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.

Description

Government should establish a committee to facilitate financial system innovation, the Innovation Collaboration (IC), consisting of senior industry, Government, regulatory, academic and consumer representatives.

The minister responsible should propose and take forward an implementation approach for forming and operating the IC. The IC should include representatives from: financial sector start-ups and innovators; consumer groups; academia; and relevant Government agencies and regulators, such as the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA), the Reserve Bank of Australia (RBA) and the Australian Taxation Office.

The IC should aim to:

- Improve Government and regulator awareness and understanding of financial system innovation and the benefits of emerging business models.¹
- Identify and promulgate action on emerging network benefits and innovation opportunities that provide user benefits and positive system-wide effects, and identify impediments to innovation.
- Facilitate interactions between financial sector innovators, Government and regulatory agencies in a single coordinated forum.
- Enable submissions to be made to the Council of Financial Regulators (CFR) where system-wide regulatory responses may be required.

1 These are often referred to as 'disruptive' business models – those that disrupt existing value chains in financial services. Examples include crowd financing mechanisms that remove the need for a financial institution to intermeditate between borrower and lender.

Objectives

- Embed understanding of, and openness to, financial sector innovation within Government and regulators through closer collaboration with industry and innovators.
- Ensure Government, regulators, industry, consumers and academia work together to identify financial system-wide opportunities and potential network benefits, where Government may need to coordinate and facilitate industry action.
- Ensure financial system innovators, start-ups and/or firms with innovative products have a single entry point for dealing with regulators and Government on innovation and a forum in which their views can be heard.

Discussion

Innovation is an essential ingredient in building a dynamic, competitive, forward-looking and growth-oriented financial system. Although the benefits of innovation are difficult to quantify, efficiency gains and improved consumer convenience are evident in a range of areas, such as online banking, payments and insurance. As the pace of technology-enabled innovation accelerates, it is crucial that Government and regulators be aware of, and enable, the benefits of innovation to flow through the financial system while appropriately managing risks.

Problems the recommendation seeks to address

Low awareness of, and impediments to, innovation

For many innovators, the entry point into the Australian financial system is via regulators: organisations with strong ‘safety’ mandates and generally low-risk appetites. Stakeholder discussions indicate Government and regulators have limited understanding of and openness to innovation, resulting in regulatory approaches that unnecessarily impede innovation in some areas. In some cases, regulators may not have regard to the whole-of-system benefits of innovation where such developments fall beyond the breadth of their existing regulatory mandates.

Siloed perspectives and inability to identify system-wide opportunities

Existing Government structures and regulatory architecture tend towards a siloed view of the financial system. They also have a low awareness of issues that are increasingly important to the financial sector (but were not traditionally so), such as data use and privacy. Lack of industry input and the absence of a system-wide perspective hamper efforts to identify system-wide opportunities and network benefits efficiently. Consequently, Government and regulators may fail to take timely, or any, action to facilitate or coordinate innovation that is beneficial to consumers and overall system efficiency.

Inability to influence Government and regulators in a coordinated way

In the absence of a forum with a system-wide view, there is no mechanism to influence Government and regulators when a coordinated change, a regulatory response or harmonised processes are needed. In some cases, innovations do not clearly fit into existing regulation or under the responsibility of a single regulator. For example, elements of some payments system innovations (discussed later in this chapter) may be affected by financial system licensing, taxation, and privacy and data requirements that fall under the remits of several regulators and Government agencies.

No single point of contact for innovators

Lack of a single point of entry for innovators, start-ups and those with innovative products can be a significant challenge given the complexity of regulation and regulatory mandates. Stakeholders, particularly new entrants, point to a lack of consolidated entry and liaison points where impediments can be discussed and, if necessary, arguments put forward for their removal. Innovators often do not have a voice with regulators or at regulatory forums and tend to have limited understanding of regulation.

Potential impacts on international competitiveness

In many countries, policy settings are deliberately pro-innovation as governments seek to foster dynamic, vibrant financial services sectors. In Asia, the monetary authorities of Hong Kong, Singapore and Malaysia, for example, have statutory mandates to promote and market financial sector development, including providing streamlined entry points for new entrants.²

The Financial Conduct Authority in the United Kingdom runs Project Innovate to support industry innovation that improves consumer outcomes.³ The United Kingdom 'fintech' industry also has its own industry body, Innovate Finance, to support technology-led financial services innovators.^{4,5} This body affords members a single

-
- 2 Hong Kong Monetary Authority 2014, *Hong Kong as an International Financial Centre*, Hong Kong Monetary Authority, viewed 31 October 2014, <<http://www.hkma.gov.hk/eng/key-functions/international-financial-centre.shtml>>; Monetary Authority of Singapore 2014, *Singapore Financial Sector*, Monetary Authority of Singapore, viewed 31 October 2014, <<http://www.mas.gov.sg/singapore-financial-centre.aspx>>; Bank Negara Malaysia 2013, *Financial Sector Development*, Bank Negara Malaysia, viewed 31 October 2014, <http://www.bnm.gov.my/index.php?ch=en_fsd&pg=en_fsd_intro&ac=737&lang=en>.
 - 3 Wheatley, M 2014, *Making innovation work for firms and customers*, address at Bloomberg by Chief Executive, Financial Conduct Authority, 19 May, London.
 - 4 'fintech' refers to a synthesis of technology and financial services.
 - 5 Innovate Finance 2014, *Vision*, Innovate Finance, viewed 16 October 2014, <<http://innovatefinance.com/#content-region>>.

point of access to regulators, policy makers, investors, customers, educators, talent and commercial partners.

Conclusion

The pace of innovation in the financial sector is rapid. Estimates suggest \$27 billion of current banking industry revenue is under threat of digital disruption.⁶ Accordingly, Government and regulators need to be aware of innovative developments to respond in a considered, timely and coordinated manner. Various industry bodies support more collaboration between industry and policy makers.⁷

With a mix of stakeholders, the recommended IC model merges industry and policy expertise to help identify innovation opportunities. Innovators could access a forum that offers them a better entry point to financial sector regulators and improves their potential to influence across agencies – if necessary, through the CFR.

The Inquiry considered alternatives to the IC model, including a solely industry-led model. However, with no direct link to Government, there was concern such a model would have limited ability to influence policy. The Inquiry also considered extending existing regulator mandates to include business promotion, as occurs in other jurisdictions. *Chapter 5: Regulatory system* recommends ASIC's mandate include a specific requirement to consider competition issues, a complement to this recommendation.

Industry should note that international experience suggests the best results for collaboration occur where the fintech industry has its own representative body of innovators and new entrants to ensure it can speak with a unified voice. Industry representatives might then also be selected and rotated from this body for the IC.

6 KPMG 2014, *Unlocking the potential: the Fintech opportunity for Sydney*, The Committee for Sydney, Sydney.

7 Refer, for example, to Australian Bankers' Association 2014, Second round submission to the Financial System Inquiry, page 80; Australian Payments Clearing Association 2014, Second round submission to the Financial System Inquiry, page 16; Association of Superannuation Funds of Australia 2014, Second round submission to the Financial System Inquiry, page 117.

Digital identity

Recommendation 15

Develop a national strategy for a federated-style model of trusted digital identities.

Description

Government should, in consultation with the private sector, develop a national identity strategy based on a federated-style model in which public and private sector identity providers would compete to supply trusted digital identities to individuals and businesses.⁸

Government should identify a minister responsible for the strategy. The strategy should detail policy principles for the model (see below), intended outcomes, an implementation approach, and a high-level structure for the trust framework⁹ needed to implement the model. Consideration should also be given to initial seed funding if required; for example, for pilot projects.

The model should be:

- Voluntary, and enable consumer choice and convenience.
- Transparent and privacy enhancing.
- Cost effective, flexible and innovative, and enable the best use of technology.
- Secure, resilient and interoperable.

A joint public-private sector taskforce should be established to develop the detail of the trust framework and standards required to deliver the model. Standards would

8 A federated model is a decentralised model where multiple identity credentials are produced by government and commercial providers to provide access to public and private sector services in a contestable market. In contrast, under a syndicated model, a single identity credential is issued, typically by government, providing single sign-on access to public and private sector services.

9 A trust framework is an agreed set of standards and rules that enables parties accepting digital identity credentials to trust the identity, security, and privacy policies of parties issuing credentials, and vice versa. OIX Open Identity Exchange 2014, *Trust Frameworks*, OIX Open Identity Exchange, viewed 19 November, <<http://openidentityexchange.org/resources/trust-frameworks/>>.

need to address identity proofing, authentication, sharing of legal liability, fraud, accreditation mechanisms for identity providers and the role of trust brokers.

Objectives

- Articulate a strategic vision and coordinated approach to digital identity management in Australia that enables the development of a competitive, innovative and dynamic market for identity services and maximises network benefits.
- Improve the efficiency of digital identity processes in the financial system, minimise costs and regulatory burden for institutions, and draw on the respective strengths and expertise of the public and private sectors.
- Facilitate innovation by improving consumer choice and convenience, and reducing friction in the digital economy.
- Ensure digital identity management processes help to prevent crime, improve security and enhance privacy.

Discussion

Box 8: The future of digital identity

Digital identity relates to how parties – whether individuals, businesses or government – confirm the identities of other parties for online financial transactions. Currently, this usually involves two main stages:

- **Identity verification.** For an individual, this is based on confirmation of attributes such as name, date of birth and address using government-issued, paper-based credentials like drivers' licences and passports. Increasingly, these attributes are able to be verified via online mechanisms.
- **Identity authentication.** After identity verification, the individual will usually be issued with credentials they can use to authenticate they are the right person when attempting to access a service. These credentials often include a user name and password plus a token or e-certificate for additional security. Over time, other methods incorporating biometrics may become more common.

The Inquiry's recommended strategy for a federated-style system of trusted digital identities would improve convenience and security for individuals by reducing reliance on paper-based mechanisms; enhance privacy and enable consumer choice in identity providers; improve efficiency by reducing repetitive processes undertaken by individuals, businesses and government, and reducing the number of credentials managed by each party; and facilitate innovation and best use of technology through the development of a competitive market for identity services.

Problem the recommendation seeks to address

Participants in Australia's financial system have always needed, and continue to need, confidence in peoples' identities. Australia's current identity infrastructure is fragmented, consisting of a largely uncoordinated network of identity credentials.¹⁰ The system has developed organically, driven by different standards, policies and legislative requirements. Australia has no clear strategic vision for digital identity management and, consequently, little coordination and limited ability to attain potential network benefits that would lower costs and reduce duplicative processes. Many public sector stakeholders have interests in digital identity management and, although Government has some existing governance mechanisms, the lack of clear ownership of identity policy is impeding progress.

Previous industry attempts to coordinate on identity issues have been unsuccessful, such as the Trust Centre initiative announced in 2006 involving a number of the major banks. Despite the potential efficiency benefits, competing commercial interests have limited industry's ability to collaborate.¹¹

Consumers' preferences for accessing financial services online are increasing the need for efficient and secure digital identity solutions. Australia's current approach to identity management results in significant process duplication, as individuals apply to, and government and businesses undertake to, verify and re-verify identities at multiple points. Traditionally, identity verification has involved paper-based and face-to-face processes, which are slow and onerous for consumers, and costly and cumbersome for organisations.

Of eight major streams of regulatory reform since 2005, research by the Australian Bankers' Association (ABA) shows industry project expenditure has been highest in relation to the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*, which includes Know Your Client (KYC) identification rules.¹² Anti-money laundering (AML) projects have resulted in an estimated \$725 million in expenditure (more than

10 No single government identity credential exists; instead, approximately 20 government agencies manage more than 50 million core identity credentials. A comparable number of credentials are also issued by private sector and other organisations. Sourced from Attorney-General's Department 2014, *National Identity Proofing Guidelines, Draft Version 5.1*, Commonwealth of Australia, Canberra, page 3. Refer also to the Interim Report for further discussion.

11 The 2006-07 Trust Centre was initiated by Westpac and involved St. George Bank, National Australia Bank and the Commonwealth Bank. Refer to Finextra 2006, 'Westpac backs customer ID management initiative', *Finextra*, 10 November, viewed 29 September 2014, <<http://www.finextra.com/news/fullstory.aspx?newsitemid=16141>>; Finextra 2007, 'Westpac exits The Trust Centre', *Finextra*, 27 November, viewed 29 September 2014, <<http://www.finextra.com/news/fullstory.aspx?newsitemid=17782>>.

12 Australian Bankers' Association 2014, data provided to the Financial System Inquiry, 9 July 2014.

Financial System Inquiry — Final report

three times as much as the next highest expenditure) related to the United States' Foreign Account Tax Compliance Act, highlighting the KYC regulatory burden and potential to reduce costs by improving identity processes.¹³

Fraud concerns are increasing, and the Australian Institute of Criminology observes that "Criminal misuse of identity not only impedes consumer activity and confidence in the financial system, but costs business and government substantial sums in responding to and preventing these crimes".¹⁴ In 2011, Australians lost an estimated \$1.4 billion through personal fraud incidents.¹⁵ Each year, an estimated 4–5 per cent of Australians experience identity crime resulting in financial loss.¹⁶ Identity theft and false identities are key enablers of superannuation fraud, and serious and organised crime.¹⁷ An enhanced digital identity infrastructure can help to reduce this risk.

Context

Existing elements for a federated-style model

Australia already has a number of elements in place for a federated-style system of trusted digital identities, as set out in *Table 7: Existing elements for a federated-style model*.

13 The other six streams were the ePayments Code, Financial Claims Scheme, Future of Financial Advice reforms, *National Consumer Credit Protection Act 2009*, over-the-counter derivatives reforms and privacy reforms.

14 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, page ix.

15 Australian Bureau of Statistics (ABS) 2012, *Personal Fraud, 2010–2011*, cat. no. 4528.0, ABS, Canberra.

16 Attorney-General's Department 2014, *National Identity Proofing Guidelines, Draft Version 5.1*, Australian Government, Canberra, page 3.

17 Australian Crime Commission 2011, *Organised Crime in Australia 2013*, Australian Government, Canberra, pages 26, 43–45, 78.

Table 7: Existing elements for a federated-style model¹⁸

Elements	Description
Document Verification Service	A secure online service that enables government agencies, financial institutions and other businesses to verify information on identity documents directly with the document issuing agency
Third Party Identity Services Assurance Framework	Framework and standards for accrediting commercial identity service providers, issued by the Department of Finance
National e-Authentication Framework	Framework and standards for authenticating the identity of another party to a desired level of assurance or confidence
National Identity Proofing Guidelines	A best-practice, risk-based approach for government to verify the identity of a person using evidence to meet the required level of assurance
Gatekeeper Public Key Infrastructure Framework	A framework that enables accredited third parties to provide digital certificates for verifying and authenticating identity when dealing with public sector agencies
myGov digital credentials	Provides secure single sign-on access to various government services including Medicare, Centrelink, electronic health records, the Australian Taxation Office, and a digital mailbox to receive government correspondence
VANguard	Delivered by the Department of Industry, VANguard acts as a 'trust broker' for business-to-government and government-to-government transactions. It provides authentication services that enable government agencies to accept a business user's previously established digital credentials such as AUSkey, Medicare and Verisign
Australian Business Register	Provides business identification services for dealing online with government, including issuance of a unique identifier, known as an Australian Business Number (ABN)
AUSkey	Linked to the ABN, AUSkey is a secure digital credential that authenticates the identity of businesses for online transactions with Commonwealth, state, territory and local government agencies
Private sector digital identity credentials	Many private sector organisations, such as banks, already have high-quality and high-assurance digital credentials in place

International and other developments

Other countries have adopted various approaches to digital identity. As noted in the Interim Report, the United States, the United Kingdom and Canada have adopted federated models. New Zealand, India and Estonia have syndicated models, with high-assurance, government-issued credentials incorporating biometrics designed to

18 Based on a number of Australian Government sources: Attorney-General's Department (AGD) 2013, *Documentation Verification Service – About DVS*, Canberra; Australian Government Information Management Office (AGIMO) 2013, *Third Party Identity Services Assurance Framework*, Department of Finance, Canberra; AGIMO 2009, *National e-Authentication Framework*, Department of Finance and Deregulation, Canberra; AGD 2014, *National Identity Proofing Guidelines, Draft Version 5.1*, Canberra; AGIMO 2009, *Gatekeeper Public Key Infrastructure Framework*, Department of Finance and Deregulation, Canberra; Australian Government, *About myGov*, Canberra; Australian Government, *VANguard Government Authentication Services: About us*, Canberra; Australian Business Register 2014, Second round submission to the Financial System Inquiry.

Financial System Inquiry — Final report

enable digital service delivery. Private sector initiatives include the work of organisations such as the FIDO Alliance, Open Identity Exchange and Edentiti.¹⁹

For entity identification, international developments include initiatives to develop a Global Legal Entity Identifier System to provide unique identifiers to companies participating in global financial markets.²⁰ The aim is to create legal entity identifiers for each entity to enable improved efficiency in global transactions.

Rationale

Developing a national identity strategy based on a federated-style model, with a framework and common standards, would support the growth of a competitive market in identity services that enables best use of technology and promotes innovation. A federated-style model suits the Australian context as Australia has not had a history of government-issued identity cards and has a strong privacy ethos compared to other jurisdictions. This model has the potential to provide consumers with choice and convenience while enhancing privacy. Australia already has in place many foundational elements for a federated-style system, and this model seeks to leverage and build on these existing effective elements.

Options considered

The Inquiry considered different models as a basis for a national digital identity strategy:

1. **Recommended:** Develop a national identity strategy based on a federated-style system in which public and private sector identity providers compete to supply trusted digital identities to individuals and businesses. Government (in consultation with the private sector) sets up a trust framework and standards to facilitate a competitive market in identity services, and enable consumer and business choice in credentials.
2. Develop a national identity strategy based on a syndicated model in which a single government identity credential is issued to provide individuals (and businesses) with single sign-on access to public and private sector services.

19 FIDO Alliance 2014, *About the FIDO Alliance*, FIDO Alliance, viewed 1 October 2014, <<https://fidoalliance.org/about>>; Open Identity Exchange (OIX) 2014, *About*, OIX, viewed 1 October 2014, <<http://openidentityexchange.org/about/>>; Edentiti 2014, *Home*, Edentiti, viewed 1 October 2014, <<http://www.edentiti.com/edentitisite/index.html#home>>.

20 Legal Entity Identifier Regulatory Oversight Committee (LEIROC), *The Legal Entity Identifier Regulatory Oversight Committee – LEIROC*, LEIROC, viewed 1 October 2014, <<http://www.leiroc.org/>>.

Option costs and benefits

National strategy for a federated-style identity model

Developing a national strategy in consultation with the private sector would support both common understanding and stakeholder buy-in. Innovation would be enhanced by a competitive market for identity providers. Several submissions note the importance of enabling continuing innovation in identity solutions.²¹ One industry body has already indicated its willingness to help coordinate industry-wide views.²² Another stakeholder supports a decentralised model, as relying on multiple possible corroborating sources of identity may prove more secure over the long term.²³

Currently, identity must be verified and authenticated at multiple points during the provision and consumption of financial services. A streamlined process would reduce the high compliance costs associated with AML KYC requirements. Within Government services, improvements in identity management are already delivering significant efficiency gains, as shown in *Box 9: myGov case study – quantification of efficiency benefits* below. The efficiency benefits of implementing coordinated digital identity management across the entire financial system are likely to be many multiples of the estimates shown below.

21 Refer, for example, to National Seniors Australia 2014, Second round submission to the Financial System Inquiry, page 30; Centre for Digital Business 2014, Second round submission to the Financial System Inquiry, page 24.

22 Australian Payments Clearing Association 2014, Second round submission to the Financial System Inquiry, page 17.

23 Centre for International Finance and Regulation 2014, Second round submission to the Financial System Inquiry, page 20.

Box 9: myGov case study – quantification of efficiency benefits

myGov is an online gateway to multiple government services using a single set of digital credentials. Almost one in three adult Australians are now registered to access government services via myGov.²⁴ The Department of Human Services conservatively estimates that myGov will generate around \$547 million in efficiency savings and reduced red tape burden over 10 years, as shown in the table below.²⁵

Considerable work is underway to simplify digital identity processes and expand the usage of myGov to other government agencies at both the Commonwealth and state/territory levels. myGov’s efficiency benefits indicate it has the potential to play an ongoing and significant role in Australia’s future identity model.

myGov element	Efficiency improvements	Average annual savings
1. Account creation and linking	Time, cost and resource savings from reduced duplication in identity verification processes and creation of accounts	\$1.7 million
2. Account management	Time, cost and resource savings from having a single account and set of credentials rather than multiple accounts	\$28 million
3. Easy access to multiple services	Improved convenience and time savings to authenticate identity for linked services	\$9 million
4. Easy access to digital mail	Improved convenience and time savings with single log-in to one mailbox for all linked services	\$2 million
5. Managing mail	Time savings from single mailbox and reduction in managing physical mail	\$14 million

Enhanced digital identity processes improve efficiency and security across the digital economy. Even in the current fragmented identity environment, one firm’s shift to electronic methods for identity verification has reduced costs by more than 30 per cent.²⁶ This firm also observed that 86 per cent of fraud and suspected money laundering events occurred where accounts had been established using face-to-face document verification after initial electronic verification failed. In contrast, 14 per cent of fraud and suspected money laundering events occurred when accounts had been opened using electronic verification.²⁷ A number of submissions note that increased

24 PSnews online 2014, ‘myGov users pass five million’, *PSnews online*, 30 September, viewed 2 October 2014, <http://www.psnews.com.au/aps/Page_psn4292.html?utm_source=psn429&utm_medium=email&utm_content=news2&utm_campaign=newsletter_aps>.

25 Department of Human Services 2014, data provided to the Financial System Inquiry, 23 September 2014.

26 ING Bank Australia 2014, Second round submission to the Financial System Inquiry, page 1.

27 ING Bank Australia 2014, Second round submission to the Financial System Inquiry, page 1.

access to government data would also improve data matching rates for identity verification.²⁸

A federated-style identity model would involve implementation and set-up costs for both Government and the private sector. This would include the initial investment to develop a trust framework. Appropriate privacy protections and mechanisms would need to be considered to maintain consumer confidence and trust in the system. Mechanisms for ongoing public-private sector collaboration and review could also be required.

National strategy for a syndicated identity model

A syndicated (centralised) system of digital identity across public and private sector services has the potential to generate the most significant network benefits. One submission advocated developing a single database for KYC to meet all local and global identity requirements to maximise cost savings.²⁹ However, a syndicated model with a high-assurance digital identity for use across the economy also involves significant costs for Government and potentially the private sector.

Public sector stakeholders indicate that current Government deployment of identity services could not be expanded simply. It would require significant further investment to ensure adequate assurance levels. For the private sector, a Government-operated system could present costs in terms of adapting to Government-issued credentials and future flexibility. It could impede the adoption of innovative solutions and deployment of the best available technology, reducing overall efficiency over time.

Many Australians may object to this option on the basis of privacy concerns. It could be viewed as a digital version of the unpopular Australia Card initiative, which was rejected in 1987, or the Access Card, which was terminated in 2007.^{30,31}

Conclusion

A national strategy based on a federated-style model best balances the attainment of network benefits with ongoing innovation in digital identity solutions, contributing to overall financial system efficiency. It draws on the strengths of the public and private

28 Refer, for example, to Association of Superannuation Funds of Australia 2014, Second round submission to the Financial System Inquiry, page 121; and ING Bank Australia 2014, Second round submission to the Financial System Inquiry, page 2.

29 Stockbrokers Association of Australia 2014, Second round submission to the Financial System Inquiry, page 11.

30 Fraser, A 2014, 'MPs urged to spruik doomed Australia Card', *The Australian*, 1 January, viewed 1 October 2014, <<http://www.theaustralian.com.au/in-depth/cabinet-papers/mps-urged-to-spruik-doomed-australia-card/story-fnkuhyre-1226792641896>>.

31 Centre for Digital Business 2014, Second round submission to the Financial System Inquiry, page 9.

Financial System Inquiry — Final report

sectors and facilitates the best use of technology. It enhances consumer choice and convenience and, with appropriate design, could enhance privacy and security. A coordinated approach would also facilitate innovation across the broader economy by helping to reduce ‘e-friction’.

A syndicated model potentially presents significant network benefits. However, there would be a trade-off with ongoing innovation in digital identity solutions, as the Government-issued identity credential would be locked in as the single solution across the system and any innovative changes would need to be driven by Government. Maintaining such a solution would be at significant cost to Government, could produce less flexible outcomes and could impede the continued best use of technology. Over time, this could result in less efficient outcomes for the financial system compared with a federated-style model.

The Inquiry believes a federated-style model is preferable on the basis of cost, innovation and efficiency, and future flexibility for consumers, businesses and Government.

Implementation considerations

Public-private sector taskforce and timing

The Inquiry recommends establishing a joint public-private sector taskforce with a set operating time frame; for example, over a 12-month period concluding at the end of 2015. The taskforce should consist of public and private sector stakeholders and, where possible, be representative of multiple sectors and levels of government. Terms of reference should be published and include dates for major milestones.

The taskforce should select a small number of pilot programs to be completed over the next two years to inform its development of the trust framework. It should consider whether any interim steps are needed to prepare for implementing the digital identity model. Steps might include amending AML KYC requirements, expanding government datasets included in the Document Verification System (DVS), enabling broader access to DVS, and changing privacy requirements for access to, and use of, certain datasets.

The taskforce should also consider establishing a mechanism to enable private sector input into the ongoing review and maintenance of the trust framework to ensure it remains fit for purpose.

Clearer graduated payments regulation

Recommendation 16

Enhance graduation of retail payments regulation by clarifying thresholds for regulation by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority.

Strengthen consumer protection by mandating the ePayments Code. Introduce a separate prudential regime with two tiers for purchased payment facilities.

Description

Australia has a complex framework for regulating payments. Relevant provisions are contained in numerous laws, regulations and instruments administered by ASIC, APRA and the Payments System Board (PSB).

- The regulators should publish a clear guide to the framework for industry, and in particular for new entrants, that outlines thresholds and regulatory requirements.

Government and ASIC, in consultation with the other regulators, should simplify and improve consumer protection regulation for retail payment service providers.³² In doing so, they should make the following changes:

- Narrow the AFSL regime for non-cash payment facilities so that only service providers that provide access to large, widely-used payment systems require an AFSL. This would remove the need to exempt services linked to small payment systems from the regime, such as public transport cards and road toll devices.
 - The thresholds of ‘large’ and ‘widely used’ could cover a system providers with annual transaction values over \$100 million and more than 50 payee groups or annual transaction values over \$500 million and more than five payee groups.
 - The definition of a payee group should be designed from the customer’s perspective. A system that provides access to several merchants would be

32 For the two payments recommendations, the term ‘service providers’ refers to entities that enable end-users (consumers and businesses) to make and receive payments in payment systems. The most common example of a service provider is a Bank. See *Figure 10: Overview of the payments system* and *Figure 11: Retail payments system fees and charges* for more information.

Financial System Inquiry — Final report

considered to provide access to a single payee group where the customer associates the merchants with a single merchant brand.³³

- Thresholds should be designed to provide clear guidance for new entrants, rather than to substantially alter the current regulatory perimeter.
- Government and ASIC should extend basic consumer protection regulation under the currently voluntary ePayments Code to all service providers.³⁴

APRA, in consultation with other regulators, should develop a separate, two-tier prudential payments regime for purchased payment facilities (PPFs)³⁵ to replace the current single-tier regime, which is a modified version of the authorised deposit-taking institution (ADI) regime.³⁶

- The new regime would offer PPFs a choice between two tiers. The lower tier would maintain the current 100 per cent liquidity ratio requirement but reduce other prudential requirements to lower compliance costs. The higher tier would reduce liquidity requirements but strengthen other prudential requirements. Lower liquidity requirements would ensure competitive neutrality between PPFs and other ADI service providers.
- APRA should publish clear thresholds for the new regime so that it only captures PPFs of sufficient scale. For example, it could only apply to PPFs that hold more than \$50 million of stored value and enable individual customers to hold more than \$1,000.³⁷ APRA should remove exemptions for services providers that do not allow deposits to be redeemed for Australian currency.³⁸

The regulators should review the extent to which their current powers enable them to regulate system and service providers using alternative mediums of exchange to

33 An example is a gift card grouping several merchants under a single shopping centre brand, or a frequent flyer program providing access to several merchants.

34 The ePayments Code is enforced by ASIC and provides some consumer protections. The code provides guidance for setting and changing terms and conditions, and rules for determining who pays for unauthorised transactions and recovering mistaken internet payments.

35 PPFs hold stored value relating to payment systems but are not traditional ADIs. An example is PayPal.

36 Some payments systems use ADI accreditation as a means of assurance for providing access their systems. The PSB should work with industry to ensure that entities regulated under the new two-tier regime, as well as entities that will shortly no longer require a specialist credit card institution ADI licence, will still be able to access core payments infrastructure, including the New Payments Platform.

37 The current prudential threshold for stored-value holdings is \$10 million.

38 This could result in prudential regulation applying to some service providers, such as providers of prepaid cards that operate on widely-used systems.

national currencies, such as digital currencies.³⁹ For example, the RBA should review the definitions in the *Payment Systems (Regulation) Act 1998* to ensure they are sufficiently broad.

Objectives

Ensure retail payments system regulation:

- Maintains confidence and trust in the payments system.
- Is better understood by industry, particularly new entrants, and accommodates rapid market development.
- Provides adequate consumer protections.
- Provides competitive neutrality for PPFs.

Discussion

Given its vital role in the economy, the payments system must be efficient and trusted. Currently, Australia's payments industry is undergoing rapid innovation, giving consumers access to an increasing array of online and mobile payment options. Over the past five years, the volume of non-cash payments in Australia has grown at an annual rate of 8–9 per cent.⁴⁰

Payments system regulation needs to be able to accommodate future changes in structure and technology. *Figure 10: Overview of the payments system* presents an overview of Australia's payments system. In the past, regulation focused on ADIs (Area A), which were the main service providers. But now, non-traditional business models have emerged (Areas B to E). The Inquiry expects that new PPFs (Area C) will emerge in the future, including PPFs that may be attached to supply chains and other on-line purchasing systems.

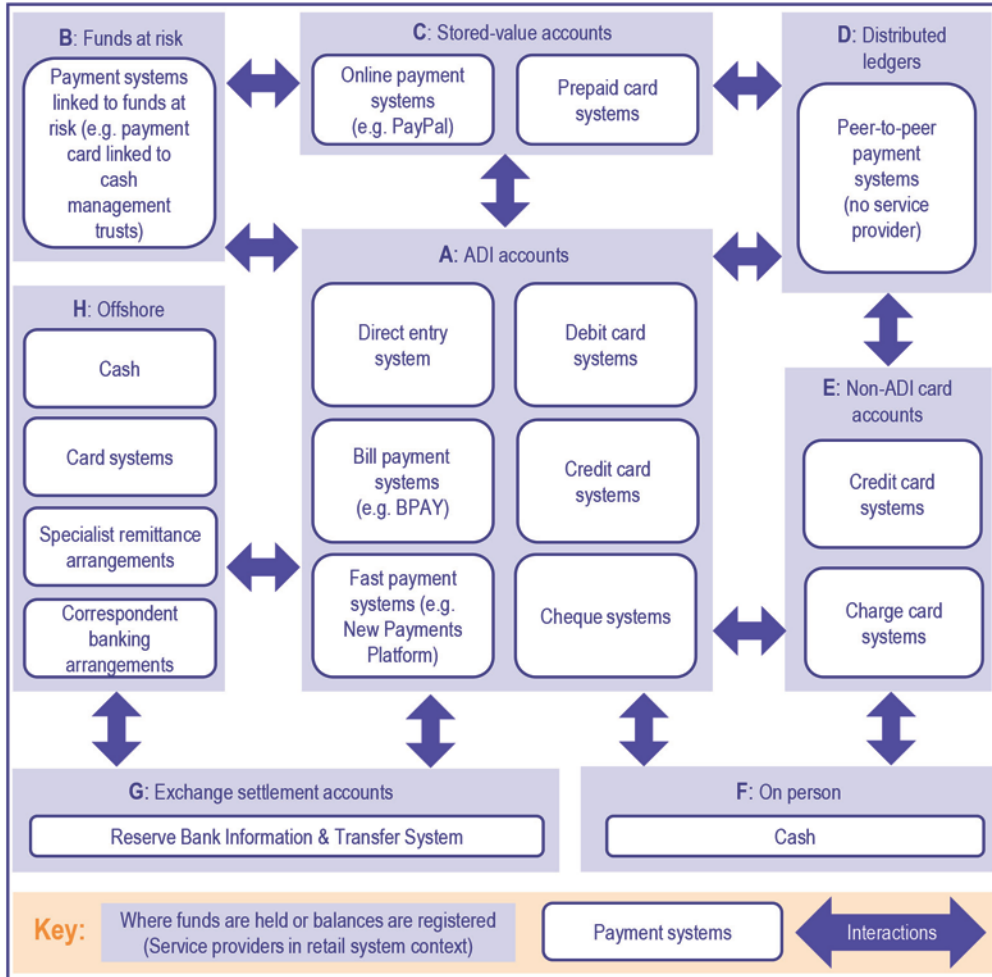
Some payment systems also incorporate new mediums of exchange such as digital currencies. International peer-to-peer networks that process digital currency payments on distributed ledgers (Area D) are difficult to regulate because there is no clearly identifiable operator.⁴¹ However, commercial services using digital currencies in 'closed loop' systems (Area C) could be regulated like other retail payment services.

39 An example of a digital currency is Bitcoin.

40 Reserve Bank of Australia (RBA) 2014, *Payments System Board Annual Report*, RBA, Sydney, page 19.

41 A distributed ledger is a public ledger for determining who owns an asset – in this case, a digital currency. Transactions are processed by open-source peer-to-peer systems and then recorded on public ledgers, of which several copies are held by users of the system. No single party operates the system or is responsible to its users.

Figure 10: Overview of the payments system



Although payment services linked to funds at risk in investment products (Area B) are rare, these could grow in the future. Eventually, these could be linked to managed investment schemes (MISs), as well as superannuation funds, allowing members to make payments with their superannuation balances during the drawdown phase.⁴² Regulation should not impede such developments.

42 The Inquiry’s recommendation would ensure that basic consumer protections would apply to these service providers, but would not affect how these service providers are prudentially regulated, as the funds used for making payments would not be considered ‘stored value’.

Problem the recommendation seeks to address

Some submissions note that current retail payments system regulation is fragmented, complex and lacks clarity.⁴³ It is not always applied on a functional basis and may not accommodate future innovation, such as digital currencies.

Elements of graduated, functional regulation exist. However, regulation generally lacks clear criteria and transparent thresholds. Combined with regulator discretion in administering the law, this generates complexity and uncertainty, particularly for new entrants.

The ePayments Code provides some consumer protections; however, it is not mandatory and as such does not cover all consumers.⁴⁴ The application of the AFSL regime is complex and costly. ASIC has given multiple class orders and individual exemptions because the breadth of current regulation captures entities that should not need an AFSL.⁴⁵

Before the Wallis Inquiry, participation in payment systems tended to be restricted to banks. Reforms post-Wallis sought to expand access to payment systems, but recognised that this could involve entities holding funds equivalent to deposits. Government sought to address this issue by introducing a prudential regime for PPFs.

However, the scope of the prudential regime for PPFs is unclear because it involves a number of exemptions and declarations.⁴⁶ The current PPF regime also involves significant compliance costs and does not provide competitive neutrality with other ADIs. Although PPFs have simpler capital requirements than traditional ADIs, they have significantly stricter liquidity requirements.⁴⁷ This can place PPFs at a competitive disadvantage and provides a perverse incentive for smaller service providers to limit their growth to avoid entering the PPF regime.

43 For example, refer to Australian Payments and Clearing Association 2014, Second round submission to the Financial System Inquiry, pages 10–11.

44 Examples of non-subscribers to the ePayments Code include a three-party system provider as well as some banks, credit unions, building societies and finance companies.

45 This has included relief for gift cards, prepaid mobile accounts, loyalty schemes and electronic road toll devices. For further details, refer to Australian Securities and Investment Commission (ASIC) 2005, *Regulatory Guide 185, Non-cash payment facilities*, ASIC, Sydney.

46 For example, whether a PPF is redeemable for Australian currency currently determines whether that facility falls within APRA's prudential regime or whether it should be subject to RBA authorisation. To date, exemptions and declarations have meant that no PPFs are authorised by the RBA.

47 PPFs must hold high-quality liquid assets that are of equal value to their stored-value liabilities, while standard ADIs have lower liquidity requirements.

Options considered

The Inquiry considered maintaining the existing approach of using various exemptions to narrow the scope of the AFSL regime to target the entities that should be regulated. Although this would involve relatively small costs over the immediate term, the complexities and impediments to innovation that the current approach creates would grow over time. A more transparent approach to regulation that does not require exemptions would improve industry understanding and provide greater certainty. The Inquiry also considered maintaining the voluntary nature of the ePayments Code as an alternative to extending it to all service providers. However, the Inquiry believes the ubiquity of electronic payments necessitates consistent consumer protections to maintain confidence and trust in the system.

The Inquiry also considered maintaining the current prudential regime for PPFs as well as reducing the liquidity requirements of the current regime. However, both approaches maintain relatively high compliance costs for PPFs with simple business models. The recommended two-tier approach allows PPFs to trade off compliance costs and competitive neutrality to suit their business models, rather than have regulation determine this for them. The Inquiry also considered maintaining the current thresholds and exemptions for applying prudential regulation, but these create uncertainty for industry. Increasing thresholds ensures smaller service providers are not unintentionally captured.

Regulators should review the extent to which their current powers enable them to regulate system and service providers using alternative mediums of exchange to national currencies, such as digital currencies. *The Payment Systems (Regulation) Act 1998* empowers the PSB to regulate “funds transfer systems that facilitate the circulation of money”. It is not clear that the PSB can regulate payment systems involving alternative mediums of exchange that are not national currencies. Currently, national currencies are the only instruments widely used to fulfil the economic functions of money – that is, as a store of value, a medium of exchange and a unit of account.⁴⁸

Digital currencies are not currently widely used as a unit of account in Australia and as such may not be regarded as ‘money’. However, their use in payment systems could expand in the future. It will be important that payments system regulation is able to accommodate them, as well as other potential payment instruments that are not yet conceived. Current legislation should be reviewed to ensure payment services using alternative mediums of exchange can be regulated – from consumer, stability, competition, efficiency and AML perspectives – if a public interest case arises. This review could take place within a broader review of the system’s capacity to accommodate future payment systems.

48 Robleh, A 2014, ‘The economics of digital currencies’, *Bank of England Quarterly Bulletin*, Q3, Vol 54, No. 3.

Conclusion

The recommended approach to clearly graduate regulation provides increased certainty to industry while accommodating innovation. The functional criteria for determining when regulation should apply are broad so thresholds can be adjusted to reflect market developments.

Replacing piecemeal exemptions in the AFSL regime with functional regulation would improve efficiency and ensure current and future business models are appropriately regulated. Extending the ePayments Code to all service providers would help protect all consumers from fraud and unauthorised transactions.

Giving PPFs flexibility could generate lower compliance costs, enhance competitive neutrality and better facilitate participation from non-traditional financial institutions, supporting innovation and competition.

Ensuring current regulation can accommodate services using alternative mediums of exchange would support innovation and confidence in the payments system.

Interchange fees and customer surcharging

Recommendation 17

Improve interchange fee regulation by clarifying thresholds for when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees.

Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.

Description

To improve the transparency and efficiency of interchange fee regulation,⁴⁹ the PSB should consider:

- Publishing thresholds for determining which system providers will be regulated.
- Broadening interchange fee caps to include all amounts paid to customer service providers in payment systems,⁵⁰ including service fees in companion card systems.⁵¹
- Lowering interchange fees by reducing interchange fee caps, but also:
 - Replacing three-year weighted-average caps with hard caps, so every interchange fee falls below the interchange fee caps. This would also reduce differences in fees paid by small and large merchants.
 - Applying caps as the lesser of a fixed amount and a fixed percentage of transaction values, instead of only one of these components.⁵² This would also

49 Interchange fee regulation is enforced through standards that cap interchange fees paid by merchant service providers to customer service providers (see *Figure 11: Retail payments system fees and charges*). The caps are currently applied on a three-year weighted-average basis. The caps are 12 cents per transaction for debit systems and 0.5 per cent of transaction values for credit systems.

50 That is, all amounts paid by merchant service providers and system providers to customer service providers.

51 These are individually negotiated fees between payments system operators and customer service providers rather than centrally established fees.

52 The proposal would add a fixed-percentage component to debit system caps (which already have a fixed-amount component) and a fixed-amount component to credit systems (which already have a fixed-percentage component).

increase the use of electronic payments for smaller-value transactions and ensure fees reflect costs for larger-value transactions.⁵³

The Inquiry considers that surcharging regulation should ensure merchants can surcharge to reflect their relative costs of accepting different payment methods.⁵⁴ This could be better achieved by providing merchants with clearer surcharging limits, which could reduce over-surcharging and improve enforceability. To implement this, the PSB should consider allowing:

- Low-cost system providers, such as systems subject to debit interchange fee caps, to prevent merchants from surcharging. This would prevent customers from being surcharged for using low-cost payment mechanisms that involve minimal acceptance costs for merchants, relative to other payment methods.
- Medium-cost system providers, such as systems subject to credit interchange fee caps, to apply surcharge limits set by the PSB. This would make it easier to prevent over-surcharging, while still allowing merchants to reflect their relative costs of accepting different payment methods.
- Higher-cost system providers to continue to apply reasonable cost-recovery rules. This would give merchants the flexibility to reflect the different costs of higher-cost payment methods.

The PSB should consider whether mechanisms are required to prevent merchants from only accepting payment methods they can surcharge. The PSB may also wish to consider other alternatives to improve the accuracy and efficiency of surcharging.

Objectives

- Clarify regulation and enhance competitive neutrality between system providers.
- Improve the efficiency and effectiveness of price signals, and reduce the potential for cross-subsidisation between customer groups and merchant groups.

53 This proposal would have a greater impact on credit systems than debit systems. If the PSB is inclined to implement this proposal for credit systems, it may wish to phase in fixed-value caps to smooth transitional costs.

54 Surcharging regulation is enforced through standards that currently prevent system providers from banning merchants from surcharging, while still allowing system providers to restrict merchants from surcharging above their reasonable cost of accepting different payment methods (see *Figure 11: Retail payments system fees and charges*).

The scenarios set out in Box 10 illustrate some of the practical outcomes these proposals could achieve, particularly in reducing costs and over-surcharging.

Box 10: Cameos on how the proposed reforms would improve outcomes

Effects of proposals for interchange fee caps

Wei Ling and Brian often purchase tacos from their favourite Mexican food truck, which is operated by small business owner, Sarinda. When Wei Ling and Brian make card payments, their banks charge an interchange fee to Sarinda's bank. Sarinda's bank charges Sarinda a merchant service fee, in part to reflect the cost of the interchange fee. Interchange fees are capped by regulation.

Current situation: Brian chooses to pay with his premium credit card because it provides frequent flyer points. His bank is able to offer these rewards because it charges high interchange fees, particularly for transactions involving small businesses like Sarinda's. These high interchange fees result in high merchant service fees for Sarinda.

Sarinda would like to charge Brian for this cost with a surcharge. However, he is reluctant as Brian may switch to one of Sarinda's competitors who does not surcharge. Instead, like his competitors, Sarinda recovers the cost through higher prices for all his customers. This penalises Wei Ling, who pays with a low-cost debit card with no rewards points.

Sarinda also sets a minimum spend of \$10 for card purchases because his fees are proportionally higher for lower-value transactions, due to the way interchange fees are set. Wei Ling only wishes to purchase a snack, but must now also purchase a drink to meet the minimum spend.

After proposed reforms: Sarinda benefits from lower interchange fee caps, which have led to lower merchant service fees. Sarinda also benefits from hard interchange fee caps, which have narrowed the difference in fees paid by small and large businesses. Like his competitors, Sarinda passes these savings onto his customers by lowering his prices to remain competitive.

Both Wei Ling and Brian benefit from the lower prices. Wei Ling particularly benefits from no longer subsidising the reward points and other benefits for customers like Brian. However, Brian now receives fewer frequent flyer points for his purchase because the interchange fees for his credit card are lower.

Wei Ling also benefits from Sarinda removing his \$10 minimum spend for card purchases, which he is able to do because fees for low-value purchases have been reduced. Wei Ling is now able to purchase a snack with her debit card, without having to buy additional items.

Effects of proposals for surcharging standards

Wei Ling wishes to purchase a plane ticket online at short notice.

Current situation: The airline imposes a \$9 surcharge for all debit and credit card purchases. For most transactions, this exceeds the airline's cost of accepting debit and credit card payments. Wei Ling cannot avoid the excessive surcharge.

After proposed reforms: Like all businesses, the airline benefits from lower interchange fees. However, it can no longer surcharge low-cost debit cards and must comply with set limits for medium-cost credit cards. Wei Ling chooses to pay with her debit card to avoid a surcharge.

Discussion

Following the Wallis Inquiry, Australia was one of the first countries to implement interchange fee caps. Interchange fee caps have since become more common and are currently applied in 38 jurisdictions.⁵⁵

As outlined in the Interim Report, the Inquiry believes interchange fee caps improve the efficiency of the payments system.⁵⁶ Without interchange fee caps, price signals for customers are less clear and outcomes are less efficient because customers can be encouraged to use higher-cost payment methods.

Figure 11: Retail payments system fees and charges shows the cycle of potential fees and charges involved in payment systems. For each transaction they accept, merchants (Box E) pay merchant service fees to merchant service providers (Box D), which in turn pay interchange fees to customer service providers (Box B). Customer service providers can then pass some of this revenue on to customers (Box A) in the form of reward points and other benefits.

Merchants can complete this cycle by surcharging their customers to recoup their transaction acceptance costs. However, this can be difficult when the system provider has high market penetration, as surcharging can cause the customer to switch to another merchant that does not surcharge.⁵⁷ Merchants can either absorb the costs of high-reward payment methods (involving high interchange fees and therefore high merchant service fees) or pass them on to all customers in the form of higher prices. Interchange fee caps restrict this cycle by limiting how much revenue customer service providers can pass on to customers using higher-cost payment methods, in the form of reward points or other benefits.

Some submissions argue that, rather than reducing the prices merchants charge for their products, interchange fee caps increase merchant profit margins.⁵⁸ They note that there is a lack of clear evidence showing caps have reduced product prices. Although caps are unlikely to result in immediate price reductions, the Inquiry agrees with the

55 Hayashi, F, Maniff, J 2014, *Interchange fees and network rules: a shift from antitrust litigation to regulatory measures in various countries*, Federal Reserve Bank of Kansas City, Kansas City, page 1.

56 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-28.

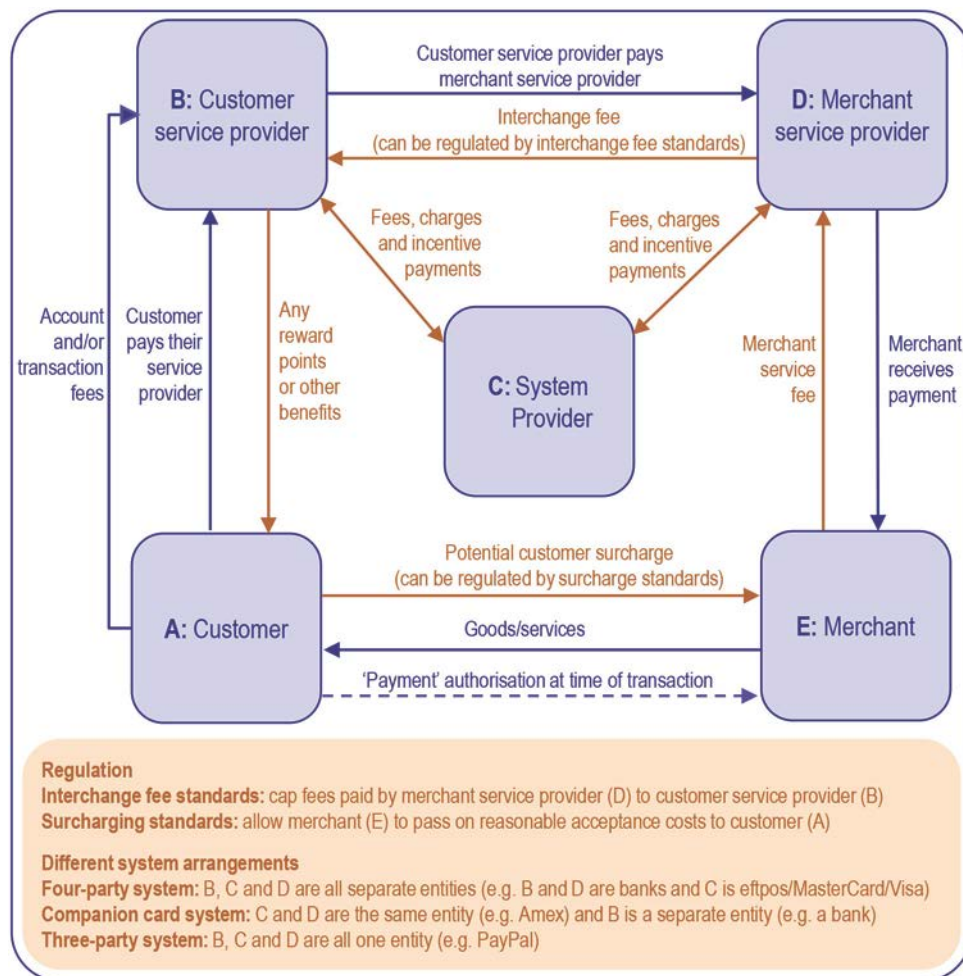
57 The Inquiry has received confidential feedback from merchants, including large merchants, that feel unable to surcharge customers due to the risk of losing customers.

58 For example, see Visa 2014, Second round submission to the Financial System Inquiry, page 14; MasterCard 2014, Second round submission to the Financial System Inquiry, page 6.

RBA that the competitive process should drive down prices over time and improve efficiency.⁵⁹

Some jurisdictions, particularly the European Union, are now implementing lower interchange fee caps than Australia and applying caps more functionally to capture all amounts paid to customer service providers.⁶⁰ The European Union is also considering allowing interchange fee-regulated system providers to impose more prescriptive surcharge rules on merchants.

Figure 11: Retail payments system fees and charges



59 Reserve Bank of Australia 2014, Second round submission to the Financial System Inquiry, page 4.

60 European Commission 2013, New rules on Payment Services for the benefit of consumers and retailers, media release, 24 July, Brussels, viewed 18 November, <http://europa.eu/rapid/press-release_IP-13-730_en.htm?locale=en>.

*Problems the recommendation seeks to address***Interchange fee caps**

Thresholds for interchange fee regulation. Currently, the rationale for limiting interchange fee regulation to selected system providers lacks transparency. Publishing thresholds for designating system providers for interchange fee standards would give system and service providers, particularly new entrants, certainty about how regulation is applied. This would support innovation by enabling providers to plan for future growth and development, and would also enhance competitive neutrality. Thresholds could be based on a combination of system providers' annual transaction values and market shares.

Broadening interchange fee caps to include all payments made to customer service providers. Incentive payments used in most systems and service fees used in companion card systems can achieve the same outcome as interchange fees; however, they are not currently captured by interchange fee caps. Applying interchange fee caps on a broader functional basis would help prevent alternative payments from avoiding caps and provide competitive neutrality for four-party and companion card payments system providers.

Lowering interchange fee caps. Payments system efficiency could be increased by lowering interchange fee caps. The Inquiry acknowledges that lowering interchange fee caps would disrupt business models and involve transitional costs. Lower interchange fee flows may cause some service providers to reduce customer rewards. The Inquiry considers that these costs would be outweighed by lower product prices for all consumers, resulting from lower fees charged to merchants, and reduced cross-subsidisation.

Replacing three-year weighted-average caps with hard caps. The current approach of using three-year weighted-average caps enables system providers to meet the caps by charging high fees for transactions involving smaller merchants without market power, while setting low fees for merchants with market power and high transaction volumes.⁶¹ Introducing hard caps would help address this imbalance while also reducing total interchange fees.

Applying caps as the lesser of a fixed amount and a fixed percentage of transaction values. Applying fixed-percentage caps to debit systems, in addition to existing fixed-value caps, would ensure low fees for small value transactions. This would increase the rate of merchants accepting these transactions. Applying fixed-value caps to credit systems, in addition to fixed-percentage caps, would ensure the proportional cost of fees decreases as the value of transactions rises, better aligning fees with the costs of processing transactions. However, this could significantly affect some credit

61 American Express 2014, Second round submission to the Financial System Inquiry, page 13.

card system and service providers. If the PSB is inclined to implement this approach, it should phase in fixed-value caps to smooth transitional costs.

The Inquiry considered banning interchange fees altogether. This could improve efficiency by forcing customers and merchants to pay directly for the benefits they each receive. There are examples of payment systems operating without interchange fees in other countries.⁶² However, the Inquiry considers that banning interchange fees would have high transitional costs. Instead, the Inquiry recommends that the PSB consider reducing interchange fees in the short term, and then consider further lowering fees in the longer term, depending on market conditions.

Table 8: Summary of interchange fee cap options

Option	Potential for inefficient cross-subsidies ⁶³	Competitive neutrality for system providers	Simplicity and clarity of regulation	Compliance costs
Recommended				
Broaden application of caps	Reduced	Increased	No change	Transitional costs
Lower caps	Reduced	No change	No change	Transitional costs
Introduce hard caps	Reduced	No change	Increased	Transitional costs
Apply caps as lesser of fixed amount and fixed percentage	Reduced	Increased	Decreased	Transitional costs (larger for credit systems)
Alternative				
Ban interchange fees altogether	Significantly reduced	No change	Increased	High transitional costs
Remove interchange fee caps	Significantly increased	Increased	Significantly increased	Decreased

Customer surcharging standards

Functional application of surcharging standards. Merchant surcharging standards do not currently apply to all system providers. This allows unregulated system providers to ban merchants from surcharging, even if they operate higher-cost systems.

62 For example, domestic debit card systems in Canada, New Zealand, Norway, Luxembourg, Finland and Denmark have set their interchange fees to zero. Hayashi, F, Cuddy, E 2014, *Credit and Debit Card Fees in Various Countries*, Federal Reserve Bank of Kansas City, Kansas City, page 5.

63 This includes cross-subsidies between customers using lower-cost and higher-cost payment methods, and between smaller and larger merchants.

Applying surcharging standards to all system providers would address this concern and ensure consistency for merchants and customers.

Providing clearer surcharging limits. The Inquiry agrees with the RBA that surcharging can improve the efficiency of the payments system by providing accurate price signals to customers.⁶⁴ In addition, some consumer groups, such as Choice, acknowledged that accurate surcharging can provide positive outcomes.⁶⁵

However, the current reasonable cost surcharge rules are difficult for system providers to enforce, potentially complex for merchants to comply with and can cause frustration for consumers, as evidenced by the more than 5,000 submissions the Inquiry received on the matter.⁶⁶ The rules are complex because each merchant needs to calculate its acceptance costs, which can involve subjective judgements about a number of factors.⁶⁷ The rules are difficult to enforce because system providers have limited visibility of these calculations.

The Inquiry proposes that the PSB consider the following alternative arrangements to simplify compliance and improve the accuracy of surcharging:

- Allow **low-cost system providers** to ban surcharges to encourage consumers to use low-cost payment methods. System providers could qualify as 'low-cost' if their interchange fees are below debit interchange fee caps. To ensure competitive neutrality, three-party systems could qualify if the costs they charge merchants are equivalent to those of other low-cost system providers.
- Allow **medium-cost system providers** to enforce set surcharge limits to simplify surcharging for merchants and improve customer understanding. The PSB could set limits to approximate payment acceptance costs. System providers could qualify as 'medium-cost' if their interchange fees are below credit interchange fee caps. To ensure competitive neutrality, three-party systems could qualify if the costs they charge merchants are equivalent to those of other medium-cost system providers.
- Allow **higher-cost system providers** to continue to enforce reasonable cost-recovery surcharging rules but require them to disclose this so their customers

64 Reserve Bank of Australia 2014, Second round submission to the Financial System Inquiry, page 6.

65 Choice 2014, Second round submission to the Financial System Inquiry, page 22.

66 These submissions were part of a campaign against surcharging, which encouraged submissions to the Inquiry. The organiser of the campaign provided a submission: Bartosch, K 2014, Second round submission to the Financial System Inquiry.

67 Reserve Bank of Australia (RBA) 2012, *Guidance Note: Interpretation of the Surcharging Standards*, RBA, viewed 3 November 2014, <<http://www.rba.gov.au/payments-system/reforms/cards/201211-var-surcharging-stds-guidance/guidance-note.html>>.

Financial System Inquiry — Final report

better understand why they may be surcharged. Although this retains the weaknesses of the current arrangements, it would be difficult to determine fixed surcharging limits for different higher-cost system providers. Maintaining the current arrangements would give merchants the flexibility to surcharge for the different acceptance costs of higher-cost payment systems.

These options could reduce over-surcharging by giving merchants clearer guidance on maximum surcharge limits. They would allow customers to avoid paying surcharges by using low-cost payment methods. The PSB should also consider whether mechanisms are required to prevent merchants from only accepting payment methods they can surcharge.

These new rules would be easier to comply with and enforce as merchants, system providers and customers would know the surcharge limits for low- and medium-cost payment methods.

These proposals would make surcharging arrangements more effective, but not perfectly accurate. The PSB would need to estimate set surcharge limits for medium-cost systems and equivalent acceptance costs for three-party systems. A transitional period would be needed to give merchants and service providers time to adapt to the new rules. The Inquiry supports the PSB considering these proposals in greater detail and implementing a solution that improves the effectiveness of surcharging.

Enforcing reasonable cost surcharge limits. The Inquiry considered imposing the current reasonable cost surcharging rules through Government regulation. However, regulators indicated this would involve considerable administration costs, as reasonable acceptance costs would need to be determined on a case-by-case basis. This option would also require strengthening regulators' powers to seek documents to prove over-surcharging, and creating new penalties to discourage over-surcharging.

Conclusion

The proposals for interchange fee standards should improve clarity, enhance competitive neutrality, improve the efficiency of price signals and reduce cross-subsidisation. The proposals for surcharging standards should make surcharging standards simpler and more accurate, while encouraging system providers that are not subject to interchange fee standards to reduce their costs.

Crowdfunding

Recommendation 18

Graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.

Description

Government should continue its current process to graduate the fundraising regime to facilitate securities-based crowdfunding. This would enable entities to make public offers of securities to a potentially large number of people (the ‘crowd’). The risks associated with crowdfunding investments would require some adjustments to consumer protections, including capping individuals’ investments and clearly communicating the risks.

Government should then use the policy settings for securities as a basis to assess wider fundraising and lending regulation to ensure it facilitates other forms of crowdfunding, including peer-to-peer lending.

A range of crowdfunding models is emerging globally. Crowdfunding facilitates the funding of projects or businesses, where small amounts of money are raised from the ‘crowd’ via an online facilitator (or platform).⁶⁸ Financial crowdfunding models include:

- **Securities-based crowdfunding**, where the ‘crowd’ invests in an issuer in exchange for securities – either equity (crowd-sourced equity funding, CSEF) or debt.⁶⁹
- **Peer-to-peer lending**, where an online intermediary facilitates lending between individuals, often in the form of unsecured personal loans, potentially to fund a business.⁷⁰

68 Crowdfunding can be financial or non-financial. Non-financial crowdfunding is where entities seek donations in exchange for some non-financial reward. This is not regulated as funding.

69 Crowdfunding does not include non-public offers of securities. In Australia, the Australian Small Scale Offerings Board provides offers of securities to retail investors under the ‘20 in 12’ prospectus exemption in s708(1) of the *Corporations Act 2001*.

70 Ontario Securities Commission (OSC) 2012, OSC Exempt Market Review: Considerations for New Capital Raising Prospectus Exemptions, *OSC Staff Consultation Paper 45-710*.

Objectives

- Graduate fundraising regulation to facilitate innovations in fundraising emerging from new technologies and ensure policy settings are consistent across funding methods.
- Provide firms, particularly small and medium-sized enterprises (SMEs), with additional funding options.

Discussion

Problem the recommendation seeks to address

Funding for SMEs is essential to facilitate productivity growth and job creation in the Australian economy. However, compared with large corporates, SMEs – particularly start-ups – generally have more limited access to external financing and higher funding costs. These issues are discussed in more detail in the Interim Report.⁷¹

Globally, crowdfunding is emerging as an alternative funding source for SMEs. Since 2009, overall fundraising via crowdfunding has grown by around 50 per cent annually, although crowdfunding still accounts for a very small share of total financing.⁷²

In Australia, current regulatory settings impede the development of crowdfunding.⁷³

- **Offers of securities** – Proprietary companies are generally prohibited from making public offers of securities (equity and debt), and shareholder numbers are capped at 50 non-employee shareholders. Start-ups or other small businesses have no viable alternative structures, as the public company structure has costly compliance requirements.
- **Peer-to-peer lending** – Licensing requirements apply to direct lender-borrower models and intermediated lending models that operate as a MIS.⁷⁴

The regulatory framework should facilitate financing via the internet.

71 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-59.

72 The European Securities and Market Authority (ESMA) surveyed estimates of market growth and size. It notes that estimates suggest “activity has been growing fast, at yearly rates above 50 per cent since 2009”, and “there seems to be a 50/50 breakdown between financial and non-financial categories”. ESMA 2014, *Position Paper: Crowdfunding*, European Union, Paris, page 3.

73 Corporations and Markets Advisory Committee 2014, *Crowd sourced equity funding: Report*, Commonwealth of Australia, Canberra, page 14.

74 For example, RateSetter and SocietyOne.

Context

Other jurisdictions are adjusting regulatory regimes to accommodate crowdfunding. For securities-based crowdfunding, both the United Kingdom and New Zealand implemented regulatory regimes in mid-2014. Canada is finalising its proposed regime for equity and debt fundraising. In the United States, regulators are yet to settle rules for CSEF.⁷⁵ Peer-to-peer lending is more advanced globally than CSEF, as accommodating peer-to-peer lending typically has required less significant regulatory adjustment.

In Australia, Government will consult on a proposed regulatory model for CSEF. The 2014 Corporations and Markets Advisory Committee's (CAMAC) CSEF report considered that, for CSEF to operate in the best interests of investors and issuers, a specific regulatory structure is required. Elements of the CAMAC proposal include:

- Placing a cap on an issuer's fundraising – no more than \$2 million in any 12-month period – and limited disclosure requirements.
- Introducing caps on investments by investors – \$2,500 per issuer, and \$10,000 overall, in any 12-month period – and communicating the high risks to investors.
- Requiring issuance to occur via a licensed intermediary that is prohibited from providing investment advice, soliciting investors and lending to investors.⁷⁶

Conclusion

The Inquiry recommends that Government should graduate fundraising regulation to facilitate securities-based crowdfunding and consider more holistic regulatory settings to facilitate internet-based financing. A well-developed crowdfunding system can aid broader innovation and competition in the financial system. Submissions generally support a more accommodative regulatory regime and note that crowdfunding would give some SMEs, particularly start-ups, more funding options.⁷⁷ Stakeholders suggest that Australia is already lagging other jurisdictions in facilitating crowdfunding.⁷⁸

75 Corporations and Markets Advisory Committee (CAMAC) 2014, *Crowd sourced equity funding: Report*, Commonwealth of Australia, Canberra.

76 Corporations and Markets Advisory Committee (CAMAC) 2014, *Crowd sourced equity funding: Report*, Commonwealth of Australia, Canberra.

77 Banki Haddock Fiora 2014, Second round submission to the Financial System Inquiry, Attachment B, page 4.

78 For example, Australian Private Equity and Venture Capital Association 2014, Second round submission to the Financial System Inquiry, page 20.

Financial System Inquiry — Final report

ASIC highlights the risks associated with crowdfunding, particularly CSEF.⁷⁹ For investors, these include fraud, issuer failure and dilution – that is, initial ‘crowd’ investors could be diluted by subsequent equity issues. For issuers, risks include action by investors if outcomes do not meet their expectations. The Inquiry acknowledges these risks. However, measures such as limiting individuals’ investments and communication to them of the risks of crowdfunding would help mitigate such concerns.

For securities-based crowdfunding, Government should promptly allow issuers to make public offers of simple securities, including common shares and non-convertible debt.⁸⁰

For peer-to-peer lending, the current MIS regime may be able to accommodate different types of platforms – including pooled investment mechanisms and ‘bulletin board’ models – where investors choose to lend to specific ventures. Consideration should be given to graduating the MIS regime, but also to facilitating other mechanisms for direct lending, with policy settings consistent with securities-based crowdfunding.

When new regulatory settings are in place, Government should monitor crowdfunding activity to determine whether settings require adjustment. Of particular interest would be consumer protection concerns and the allocative efficiency of crowdfunding. To this end, crowdfunding platforms could be required to make information about their activities public, which would support research and policy analysis.⁸¹

Other recommendations in this chapter could help facilitate crowdfunding, including *Recommendation 14: Collaboration to enable innovation*, *Recommendation 19: Data access and use* and *Recommendation 20: Comprehensive credit reporting*.

79 Australian Securities and Investments Commission, First round submission to the Financial System Inquiry, pages 84–85.

80 This approach is similar to that being considered by the Ontario Securities Commission (OSC). OSC 2014, *Introduction of Proposed Prospectus Exemptions and Proposed Reports of Exempt Distribution in Ontario*, OSC, Ontario.

81 Such as funds raised, average investment, and degree that offers are over- or under-subscribed.

Data access and use

Recommendation 19

Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.

Description

Government should commission the Productivity Commission (PC) to commence, by the end of 2015, an inquiry into the costs and benefits of increasing access to and improving the use of data, subject to privacy considerations. Increasing access to data could enhance consumer outcomes, better inform decision making, and facilitate greater efficiency and innovation in the financial system and the broader economy but could also involve privacy risks.

The PC should consider potential mechanisms to:

- Increase private sector, academic and community access to public sector data.
- Encourage the use of appropriately de-identified public data to inform government, private sector and consumer decision making.
- Improve individuals' access to public and private sector data about themselves, such as by defining relevant data, standardising its collection and aggregation in datasets, and formalising access entitlements and arrangements.
- Increase access to private sector data while maintaining private sector incentives to collect data, such as through data-sharing arrangements, cost-recovery arrangements and user charges.
- Further standardise the collection and release of public and private sector data and product information, so datasets can be created and combined more effectively.
- Enhance and maintain individuals' confidence and trust in the way data is used.

The PC should report to the Treasurer on how better use of data can improve user outcomes, including potential amendments to the *Privacy Act 1988* (Privacy Act) and other legislation.

Objectives

- Improve the quality of business and consumer decision making, public policy development and implementation, and research into how the financial system and broader economy function.

Financial System Inquiry — Final report

- Better enable innovative business models that rely on data, where they improve user outcomes and overall system efficiency.
- Increase the utility of public institutions that hold data.

Discussion

Problem the recommendation seeks to address

Data is becoming increasingly integral to how the financial system and broader economy function. By 2020, the amount of data held globally is predicted to be 44 times larger than it was in 2009.⁸² Ever-expanding computational power and smarter algorithms are enabling this data to be used more effectively. This is helping businesses better understand and meet the needs of consumers, improve product offerings, manage risks and reduce costs.

National governments globally are encouraging these trends through open data policies.⁸³ Some private sector organisations, non-government organisations and academic institutions have also incorporated open data policies or are actively contributing to the amount of publicly available data.⁸⁴ However, to date, and especially in Australia, there has been very little debate around whether Government policies could increase access to private sector data to boost innovation and competition.

The increasing use of data is not without risk. The 2014 update of the Australian Privacy Principles made significant progress in defining how individuals can access and control their personal data.⁸⁵ Globally, there is growing debate about the use of data and how societies should balance privacy and efficiency considerations.⁸⁶

The scenario set out in *Box 11: A cameo on the potential benefits of enhanced data usage*, based on existing and/or emerging data-driven financial products and services from around the world, highlights the power of data to drive competition and improve user outcomes.

82 Gantz, J and Reinsel, D 2010, *The digital universe decade – are you ready?* International Data Corporation iView, Framingham, Massachusetts, page 2.

83 Davies, T 2014, *Open data policies and practice: an international comparison*, Paper for European Consortium for Political Research Panel P356 – *The Impacts of Open Data*, page 1.

84 Herzberg, B 2014, *The Next Frontier for Open Data: An Open Private Sector*, World Bank, viewed 22 October 2014, <<http://blogs.worldbank.org/voices/next-frontier-open-data-open-private-sector>>.

85 *Privacy Amendment (Enhancing Privacy Protection) Act 2012*, which amends the *Privacy Act 1988*.

86 For example, see Acquisti, A 2010, *The Economics of Personal Data and the Economics of Privacy*, Organisation for Economic Co-operation and Development, Paris.

Box 11: A cameo on the potential benefits of enhanced data usage

Sarinda owns a food truck business, Happy Jalapeños, which he has operated for 18 months. He uses payments service provider, SnappyPay, for a mobile point-of-sale solution, which enables him to track his sales, take pre-orders online and accept card payments with an attachment on his smart phone. As part of its service, SnappyPay collects Happy Jalapeños' payments data.

The following example shows how Sarinda's business operates in the current Australian context, and then how emerging data driven financial products and services could enhance Sarinda's business.

Improving access to finance

Sarinda wishes to expand his business by buying a second truck.

Current situation: Sarinda has limited personal savings and collateral. The traditional banking sector is reluctant to lend to Sarinda without collateral and places limited weight on alternative means of assessing creditworthiness such as cash flow data. Sarinda is also unable to easily compare credit products due to a lack of standardised product data.

Potential future situation: Based on an analysis of 18 months of Happy Jalapeños' cash flow data, SnappyPay identifies Sarinda as an attractive loan candidate and offers him a customised loan to match his needs. Sarinda compares SnappyPay's offer with competing products by inputting his loan needs and standardised cash flow data into a comparator site.

By accessing credit providers' standardised product data, the site matches Sarinda's needs with the best available products from various lenders, including banks, peer-to-peer lenders and other providers. The comparator site is also able to identify crowd sourced equity options. Sarinda is able to select the financing option that best suits his needs.

Facilitating growth and competition

Sarinda wishes to better understand his business and competitive environment.

Current situation: While Sarinda knows he is not fully tapping the potential of his business, he is unable to afford the data analytics capabilities his larger competitors possess. He also has limited access to competitor data due to privacy safeguards and a lack of relevant data sets. Instead, he relies on his business intuition and observes trends while operating his food truck.

Potential future situation: Through SnappyPay, Sarinda is easily able to review Happy Jalapeños' sales and cash flow data. He enters a reciprocal data-sharing agreement under which Happy Jalapeños' data is de-identified and aggregated into industry-wide data he can then access for competitor analysis. He also consents to sharing his truck's real-time geolocation data in exchange for the geolocation data of other nearby trucks.

With analytics support, Sarinda can identify peak and off-peak sales periods throughout each day, and across the year, to better target his promotional offers. He is able to adjust his food and beverage offerings to match trending and popular products. He is also able to determine the best location for his truck throughout each day.

Access to public sector information

As the PC has previously noted, “... unlike many other countries, Australia makes relatively little use of its public [sector] data resources, even though the initial costs of making data available would be low relative to the future flow of benefits”.⁸⁷ The National Commission of Audit noted that Australian governments have only released around 3,200 datasets, compared with 10,000 datasets in the United Kingdom and 200,000 datasets in the United States.⁸⁸ The PC also observed that, “... academics, researchers, data custodian agencies, consumers and some Ministers are eager to harness the evidentiary power of administrative data, but this enthusiasm generally is not matched by policy departments”.⁸⁹

This reluctance could be due to the costs of making data available and usable, and risks around quality assurance. However, these considerations should be weighed against the fact that decisions not to release data prevent public and private sector decisions from being better informed. The Inquiry is mindful that financial regulators release significant amounts of data, but sees scope to release more, including both aggregated data and de-identified datasets of personal information.

Access to personal information

The Australian Privacy Principles give individuals the right to access personal information about themselves; however, a number of impediments are still preventing consumers from being able to use their data effectively:

1. Little guidance is available on how personal information should be provided, including delivery method, timelines and standards for representing data.
2. In most cases, consumers are unable to authorise trusted third parties to access their personal information directly from their service provider. This reduces the ability of competitors to offer consumers better value or tailored services, or develop advice services to better inform consumer decision making.

87 Productivity Commission 2013, *Annual Report 2012–13*, Chapter 1: Using administrative data to achieve better policy outcomes, Commonwealth of Australia, Canberra, page 1.

88 National Commission of Audit 2014, *Towards Responsible Government: The Report of the National Commission of Audit, Phase One*, Chapter 10.5: Data, Commonwealth of Australia, Canberra, page 235.

89 Productivity Commission 2013, *Annual Report 2012–13*, Chapter 1: Using administrative data to achieve better policy outcomes, Commonwealth of Australia, Canberra, page 1.

3. Confusion exists over what constitutes personal information, which may limit individuals' access to data.⁹⁰

Access to private sector data

In many circumstances, private sector organisations have strong incentives to restrict access to the data they hold, as it serves as a competitive advantage. However, this may create inefficiencies where the benefits to the economy of releasing data are greater than the benefits to individual institutions of restricting access. In this sense, publicly accessible data can suffer from the 'common good' problem: it is undersupplied because the gains to society are difficult to monetise.

The Inquiry does not suggest that all, or even most, private sector data should be released publicly. In many cases, private returns are necessary to justify investments in developing datasets. The challenge is to maintain commercial incentives for developing datasets, while facilitating the release of data where this improves efficiency.

Standards for datasets and product information

Standards for collecting and representing data can improve the use of data and enhance its network qualities. They can enable datasets to be combined and aid algorithms that mine datasets to find meaning. Although progress has been made in standardising data collection, particularly through programs such as Standard Business Reporting, much work still needs to be done. In some cases, poor coordination prevents standards from being developed or widely used. Another contributing factor is the cost involved in adjusting how data is collected and represented to comply with standards.

Confidence and trust

For the potential of data to be fully realised, individuals must have confidence and trust in how their personal information is stored and used. Without confidence and trust, individuals would be unwilling to volunteer their personal information and may avoid using services that develop datasets based on observations of individuals' behaviour.⁹¹ Some reports suggest that individuals do not understand how their

90 For example, see Grubb, B 2014, 'Spies can access my metadata, so why can't I? My 15-month legal battle with Telstra', *Sydney Morning Herald*, 10 October, viewed 23 October 2014, <<http://www.smh.com.au/digital-life/consumer-security/spies-can-access-my-metadata-so-why-cant-i-my-15month-legal-battle-with-telstra-20141010-1146qo.html>>.

91 For example, payment services that collect data on individuals' purchasing decisions.

Financial System Inquiry — Final report

personal information is currently collected and used. When they do find out, they can lose trust and may stop using services that collect their personal information.⁹²

Rationale

A number of submissions support data sharing within privacy limitations and increasing the use of standards, including those from Choice, the Office of the Australian Information Commissioner, the Association of Superannuation Funds of Australia and the ABA. Others note the benefits to policy makers, regulators and researchers of having access to high-quality data for understanding how the financial system functions and improving policy decision making.⁹³ Although issues regarding accessing and using data are important for the financial system, they also have much broader implications.

The outcomes of the proposed PC inquiry should improve the way Australia's financial system data ecosystem functions by increasing data sharing and the utility of datasets. As the Privacy Act has only recently been updated after an extensive review, any PC recommendations to amend the Privacy Act could be considered in a broader post-implementation review of the Privacy Act. This would ensure another forum to explore potential trade-offs between efficiency and protecting individuals' privacy. Both processes would foster much-needed public debate on these complex issues, which Government, business and society will need to grapple with for some time to come.

Option considered

Recommended: The PC should consider the costs and benefits to the financial system and broader economy of mechanisms to: increase access to public sector data; individuals' access to their personal information; access to private sector data; the use of standards for datasets and product information; and confidence and trust in the use of data. The PC should recommend where amendments to the Privacy Act and other legislation could enable better use of data and improve public welfare.

Option costs and benefits

The costs and benefits of potential options the PC inquiry could consider are discussed below. The cost of the actual PC inquiry is likely to be minimal, considering the potential benefits of improving the use of data.

92 For example, see World Economic Forum and Bain and Company 2011, *Personal Data: The Emergence of a New Asset Class*, World Economic Forum, page 6.

93 For example, see Centre for International Finance and Regulation 2014, Second round submission to the Financial System Inquiry, pages 20-21.

Access to public sector data

Broadening access to public sector data has significant benefits. One report suggests this could add around \$16 billion per annum to the Australian economy, as a conservative estimate.⁹⁴ The Inquiry strongly supports the National Commission of Audit's recommendations to extend and accelerate publishing de-identified administrative data and stocktake suitable datasets for public release.⁹⁵

However, the main challenge will be overcoming the disincentives to release data. The PC may wish to consider price signals to address this, such as a program that provides additional funding to agencies for the first year they release new datasets or charging agencies for each year they do not release data.

Access to personal information

Some submissions note that individuals would benefit from being able to access their personal information more readily and in more standardised formats, such as in machine-readable format, and from being able to share their information with trusted third parties more seamlessly.⁹⁶ Consumers could better understand their circumstances and improve their decision making, as well as identify better-value offerings from other service providers.

Consumers are increasingly using online resources to inform their financial decision making – up from 25 per cent in 2005 to 40 per cent in 2011,⁹⁷ and the Inquiry believes this could grow significantly. When considering options in the Australian context, the PC may wish to consider regulatory models such as 'midata' in the United Kingdom⁹⁸ and Smart Disclosure in the United States.⁹⁹ It may also be possible to create standard protocols to enable consumers to allow trusted third parties to access some of their personal information. For example, the PC could consider whether introducing such standards could facilitate opportunities for 'data banks' to store personal data that

94 Lateral Economics 2014, *Open for Business: How open data can help achieve the G20 growth target*, Lateral Economics, Melbourne, page 10.

95 National Commission of Audit 2014, *Towards Responsible Government: The Report of the National Commission of Audit, Phase One*, Chapter 10.5: Data, Recommendation 61, Commonwealth of Australia, Canberra, page 236.

96 Refer, for example, to Choice 2014, Second round submission to the Financial System Inquiry, pages 26–31.

97 ANZ 2011, *Adult Financial Literacy in Australia: Full report of the results from the 2011 ANZ Survey*, ANZ, Melbourne, page 102.

98 United Kingdom Department for Business, Innovation and Skills 2011, *The midata vision of consumer empowerment, media release, 3 November*, London, viewed 18 November 2014, <<https://www.gov.uk/government/news/the-midata-vision-of-consumer-empowerment>>.

99 United States Government 2014, *An introduction to smart disclosure*, Data.gov, Washington DC, viewed 11 November 2014, <<https://www.data.gov/introduction-smart-disclosure-policy/>>.

individuals volunteer. Individuals could then choose to provide access to parts of this information to trusted third parties.

Access to private sector data

Increasing access to private sector data would have large efficiency benefits across the economy. It would support innovation and competition, as new entrants and smaller businesses with smaller datasets could better compete with larger incumbents. Online comparator sites and other advice services could better serve their clients, and consumers could make more informed choices. Industry and government should continue to progress initiatives for sharing data with consent, and initiatives allowing greater access to commercial data where this would improve user outcomes. In particular with greater flexibility of disclosure mechanisms, issuers and firms should make available prominently and publicly at no cost, mandated disclosure in a central place. For example, all PDSs of an issuer could be made available on their website.

The PC should consider the conditions under which the release or sharing of private data would create net benefits to the economy, and not reduce incentives for businesses to collect the data in the future. In many cases, potential disincentives could be addressed by compensating businesses that share their data. It may be efficient to charge users of data to fund this compensation, such as through an access regime. In other cases, businesses could be compensated through greater access to others' data.¹⁰⁰ Alternatively, if the data is viewed as a 'pure' public good, Government may be justified in compensating providers and releasing the data for free.

Standards for datasets and product information

Standardising datasets can improve data functionality by improving ease of use and allowing datasets to be combined. This can assist the process of turning data into meaningful information. The Standard Business Reporting initiative has invested considerable resources to standardise financial datasets and currently operates on a voluntary basis.¹⁰¹ The PC may wish to consider whether additional actions are necessary to unlock the potential of data through standardisation — both for public and private sector datasets.

Standards could also cover how financial product information is reported, so third parties could use automated processes to create market-wide datasets of available products.¹⁰² The Inquiry believes new advice and comparison services would be

100 For example, financial institutions share consumer credit data through credit bureaus.

101 Australian Business Register 2014, Second round submission to the Financial System Inquiry, page 2.

102 For example, a 2010 Choice survey found that credit card providers use at least 10 different billing methods, making it difficult for consumers to compare information. Choice 2014, Second round submission to the Financial System Inquiry, page 27.

developed if product information was better standardised, supporting consumers in making more informed choices and enhancing competition.

Although the Inquiry's first preference would be for private sector models to develop, some stakeholders are concerned that comparison services can face conflicted incentives, which may lead them to provide poor advice or misleading comparisons.¹⁰³ The PC may wish to consider these issues, particularly in circumstances where Government provision is the most effective option.¹⁰⁴ Government provision can avoid conflicted incentives, but it can come at a cost to taxpayers and involve moral hazard. The Inquiry encourages the PC to consider these issues further.

Confidence and trust

Increasing confidence and trust in the way data is collected and used can increase the amount of data institutions are able to collect and use. As a result, some restrictions on the use and collection of data can actually increase the amount of data available. The Privacy Act is a vital piece of infrastructure in Australia's data ecosystem.

The PC may wish to consider other means of enhancing confidence and trust and reduce the risk of it being eroded. These outcomes can be achieved by ensuring individuals benefit from sharing their personal information and have visibility and control over how their information is used. Specific options could include standardising processes for correcting data errors and limiting how widely data can be shared. Increasing transparency through data breach reporting and greater disclosure of how data is used and collected could also assist, particularly in building sustainable levels of confidence and trust over time. The PC may also wish to consider how to best balance efficiency and security in relation to controls on international data transfers.

Conclusion

The PC is best placed to consider the costs and benefits to consumers, the financial system and the broader economy of increased access to and improved use of data, and to explore options the Inquiry has not considered.

103 Choice 2014, Second round submission to the Financial System Inquiry, supplementary document, page 3.

104 There are already examples of state governments providing comparator services for electricity and gas (see www.yourchoice.vic.gov.au and www.energymadeeasy.gov.au), and the Federal Government will establish a comparator service for insurance in North Queensland by March 2015. Cormann, M (Minister for Finance and Acting Assistant Treasurer) 2014, Initiatives to help address insurance affordability for North Queensland, media release, 23 October, Canberra, viewed 23 October 2014, <<http://www.financeminister.gov.au/media/2014/1023-initiatives.html>>.

Comprehensive credit reporting

Recommendation 20

Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime. If, over time, participation is inadequate, Government should consider legislating mandatory participation.

Description

Industry should continue to implement the new comprehensive credit reporting (CCR) regime on a voluntary basis. This would allow credit providers to share individuals' 'positive' credit history data, such as loan repayment history.

Industry believes that CCR will not be operational until March 2015, at the earliest. Also, industry suggests that significant portions of credit data will not be exchanged until late 2016 or early 2017, reflecting, in part, major transitional issues for credit providers.¹⁰⁵

In 2017, Government should review industry's participation in CCR to determine whether a regulatory incentive or legislation for mandatory reporting is required. Government could also consider expanding CCR to include more data fields.

Objectives

- Reduce information imbalances between lenders and borrowers, and facilitate competition between lenders.
- Improve access to and reduce the cost of credit for borrowers, including SMEs.

Discussion

Problem the recommendation seeks to address

Industry participation in CCR

At present, credit providers have limited access to credit data on competitors' customers. The previous credit reporting regime was based on sharing 'negative' credit events, such as an individuals' history of defaults.

¹⁰⁵ Australian Retail Credit Association (ARCA) 2014, *Additional material to the Financial System Inquiry*, ARCA, Sydney, page 4.

More comprehensive sharing of credit data would reduce information imbalances between lenders and borrowers. It would also facilitate borrowers switching between lenders and greater competition among lenders. Overall, more comprehensive credit reporting would likely improve credit conditions for borrowers, including SMEs. Personal credit history is a major factor in credit providers' decisions to lend to consumers, but also to new business ventures and smaller firms.

Empirical evidence suggests CCR reduces the likelihood that originated loans will default (reducing interest rates) and/or increases the availability of credit.¹⁰⁶ Most OECD countries have some form of 'positive' credit reporting, either via a public credit register or private reporting body, reflecting the benefits of more comprehensive credit reporting.¹⁰⁷

In Australia, legislation for CCR came into effect in March 2014, although the regime is not yet fully implemented. Industry is developing a data-sharing agreement based on reciprocity between credit providers. Under the proposed agreement, each participant would select the data categories they wish to share, and in turn gain access to the same categories from other participants (via credit reporting bodies). Data exchange would be supported by a compliance framework, where participants would be able to raise instances of non-compliance by other participants.¹⁰⁸ The Australian Retail Credit Association (ARCA) anticipates finalising the agreement by March 2015 at the earliest.¹⁰⁹

Participation in CCR is voluntary, so the pace and extent of eventual participation in the regime is not yet clear.

For credit providers, participation will depend on the perceived net benefits, which will differ between different classes of credit provider. For a major institution with a relatively large customer base, early and full participation may provide, at least

106 International Finance Corporation 2012, *Credit Reporting Knowledge Guide*, International Finance Corporation (part of the World Bank), Washington, DC. Also see Barron, J and Staten, M 2003, 'The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience', in *Credit Reporting Systems and the International Economy*, ed. Miller, M, MIT Press, Boston.

107 Expert Group on Credit Histories (to the European Commission) 2009, *Report of the Expert Group on Credit Histories*, DG Internal Market and Service, Paris; Rothmund, M and Gerhardt, M 2011, *The European Credit Information Landscape*, European Credit Research Institute, Brussels; Australian Law Reform Commission 2008, *Australian Privacy Law and Practice*, Volume 3, Report 108, Commonwealth of Australia, Canberra.

108 The Australian Retail Credit Association (ARCA) 2014, Second round submission to the Financial System Inquiry, page 3. Under the proposed agreement, there are three tiers of data: negative (data typically disclosed pre-March 2014); partial (information on current credit accounts, plus 'negative' data); and comprehensive (repayment history plus 'partial' data).

109 The Australian Retail Credit Association (ARCA) 2014, Second round submission to the Financial System Inquiry, page 4.

Financial System Inquiry — Final report

initially, relatively larger benefits to other, smaller participants than for the institution itself.

As participation and system-wide data grow, net benefits increase for all CCR participants. Further, credit providers that do not participate are at risk of adverse selection with respect to potential new borrowers; a risk that becomes more acute as industry participation increases.¹¹⁰

Ultimately, the system would be expected to deliver better credit outcomes for providers that participate relative to those that do not. It is difficult to determine *ex ante* the level of participation at which this would occur, but Veda suggests that this is likely to occur before participation reaches 50 per cent.¹¹¹

Extension to SME data

Submissions generally argue that the costs of mandatory reporting of SME data would outweigh the benefits. Reporting of SME data would impose further compliance costs on credit providers. However, the additional data would not likely reduce information imbalances. This is because the credit health of the business owner(s) as an individual remains the primary information source for credit decisions, rather than information about the SME itself.

Expanding CCR data fields

Submissions generally support expanding CCR data with more data fields – particularly account balances. However, additional data fields would have to be balanced against privacy concerns, and would require amendment of the Privacy Act. The need for additional data fields could be considered in the proposed review of CCR participation and the proposed PC inquiry into data access and use (see the previous recommendation).

Conclusion

The Inquiry believes that CCR would lead to better credit decisions across the system including for SMEs, and supports industry efforts to expand credit data sharing under the new voluntary CCR regime. However if, over time, participation is inadequate, Government should consider legislating mandatory industry participation, or a regulatory incentive. The Inquiry does not support mandating reporting of SME data.

In principle, the Inquiry supports expanding the number of CCR data fields, as theoretical and empirical studies suggest that more, high-quality credit data lead to better credit decisions and improved credit conditions for borrowers.

110 Johnson, S 2013, 'Consumer lending: implications of new comprehensive credit reporting', *JASSA – The FINSIA Journal of Applied Finance*, no. 3.

111 Based on modelling undertaken by Veda (a major credit bureau), which models the impact of rising industry participation in comprehensive credit reporting on lenders' credit decisions.

Chapter 4: Consumer outcomes

The financial system plays a vital role in meeting the financial needs of individual Australians. To fulfil this role effectively, consumers should be treated fairly and financial products and services should perform in the way consumers are led to believe they will. Consumers have a responsibility to accept their financial decisions, including market losses, when they have been treated fairly. However, financial system participants, in dealing with consumers, should have regard to consumer behavioural biases and information imbalances. Recent consumer experiences reveal poor industry standards of conduct and areas for enhancement in the current framework.

The current regulatory framework focuses on disclosure, financial advice and financial literacy, supported by low-cost dispute resolution arrangements. Product disclosure plays an important part in establishing the contract between issuers and consumers. However, in itself, mandated disclosure is not sufficient to allow consumers to make informed financial decisions. As the Interim Report noted, affordable, quality financial advice can bring significant benefits to consumers, especially where they may not be equipped to make complex financial decisions.

The framework needs to more effectively align the governance and corporate culture of financial firms, employees and other representatives. Currently, in seeking to align commercial incentives with consumer outcomes, the regulatory framework is focused on point of sale. Recent examples of poor conduct suggest the alignment needs to start at the point of product design, and then be strengthened through distribution and advice.

Improved financial literacy enables consumers to be more engaged and to make more informed decisions about their finances. The Inquiry notes support from submissions on the importance of financial literacy for consumers. There are numerous examples of financial industry and Government programs that aim to educate consumers and raise their awareness of financial management issues, and the Inquiry encourages continuation of these efforts. However, in the Inquiry's view, increasing financial literacy is not a panacea. Further measures are needed to support the fair treatment of consumers.

The Inquiry also supports continuing industry and Government efforts to increase financial inclusion. Reviews and proposed changes to the financial services framework should involve consumer organisations in policy development, alongside industry, regulators and other stakeholders.

In making its recommendations, the Inquiry has deliberately focused on the issues of most concern and has not suggested changes to current arrangements that are

Financial System Inquiry — Final report

generally working well, such as alternative dispute resolution systems. The Inquiry recognises the importance of continuing to have an adequate consumer dispute resolution system.

The Inquiry also considered the scope for self-regulation. Industry self-regulatory approaches are often more successful in setting governance, customer service or technical standards that supplement the law, than in addressing sector-wide conduct issues, particularly where there are commercial pressures that may undermine standards. In some cases, there may also be a first-mover disadvantage. In these cases, government regulation may be required. On this basis, the Inquiry looks to firms and industry to take forward initiatives for a number of the recommendations in this chapter. These include raising industry standards and levels of professionalism, more effectively disclosing risk and fees, and improving guidance and disclosure for general insurance.

This Inquiry's recommendations focusing on consumer outcomes, in this and related chapters, combine deregulatory elements, self-regulation and new regulation. They build on recent changes, such as the Future of Financial Advice (FOFA) and product disclosure reforms, accommodate and promote market discipline and aim to reduce calls for future significant changes to the regulatory framework.

A number of recommendations focus on increasing accountability of issuers and distributors. In the Inquiry's view, firms that already invest in customer-focused business practices and procedures would not be required to change their operations significantly. The Inquiry's expectation is that costs involved in changing practices should be low. In addition, the Inquiry believes that, in complying with these recommendations, firms would also be likely to benefit from long-term savings through increased customer retention and avoid further regulatory costs.

In the Inquiry's view, these recommendations should also have limited effect on incentives for product innovation. To the extent that there is a change in the design or distribution of certain products, the Inquiry considers that this is appropriate to promote consumers buying products that meet their needs.

Underlying a regulatory framework is the essential requirement that regulators are strong, independent, accountable and focused on enforcing the existing framework in a timely and proactive way. This chapter should therefore be read together with *Chapter 5: Regulatory system*, which makes recommendations to strengthen the Australian Securities and Investments Commission (ASIC).

Recommended actions

The Inquiry recommends taking the following actions to promote the fair treatment of consumers, to improve efficiency and build confidence and trust in the financial system.

1. Make issuers and distributors more accountable for design and distribution of products and introduce a product intervention power. To promote positive consumer outcomes, product issuers and distributors should take greater responsibility for the design and targeted distribution of products. This should strengthen consumer confidence and trust in the system and reduce the number of cases where consumer behavioural biases and information imbalances are disregarded. ASIC should also be enabled to take a more proactive approach to reduce the risk of significant detriment to consumers.

2. Focus financial firms and advisers on the interests of consumers. To build confidence and trust in the financial system, firms need to take steps to create a culture that focuses on consumer interests. This should include addressing conflicted remuneration in life insurance advice and stockbroking. Underscoring the importance of improved standards and accountability, the Inquiry recommends giving ASIC enhanced powers to ban individuals from financial firm management. The Inquiry recommends lifting the minimum competency standards for financial advisers, improving transparency of adviser firm ownership and relabelling general advice (see also *Recommendation 40: Provision of financial advice and mortgage broking*). In addition, the Inquiry recommends enabling better access to quality guidance for home building and contents insurance to reduce the risk of underinsurance.

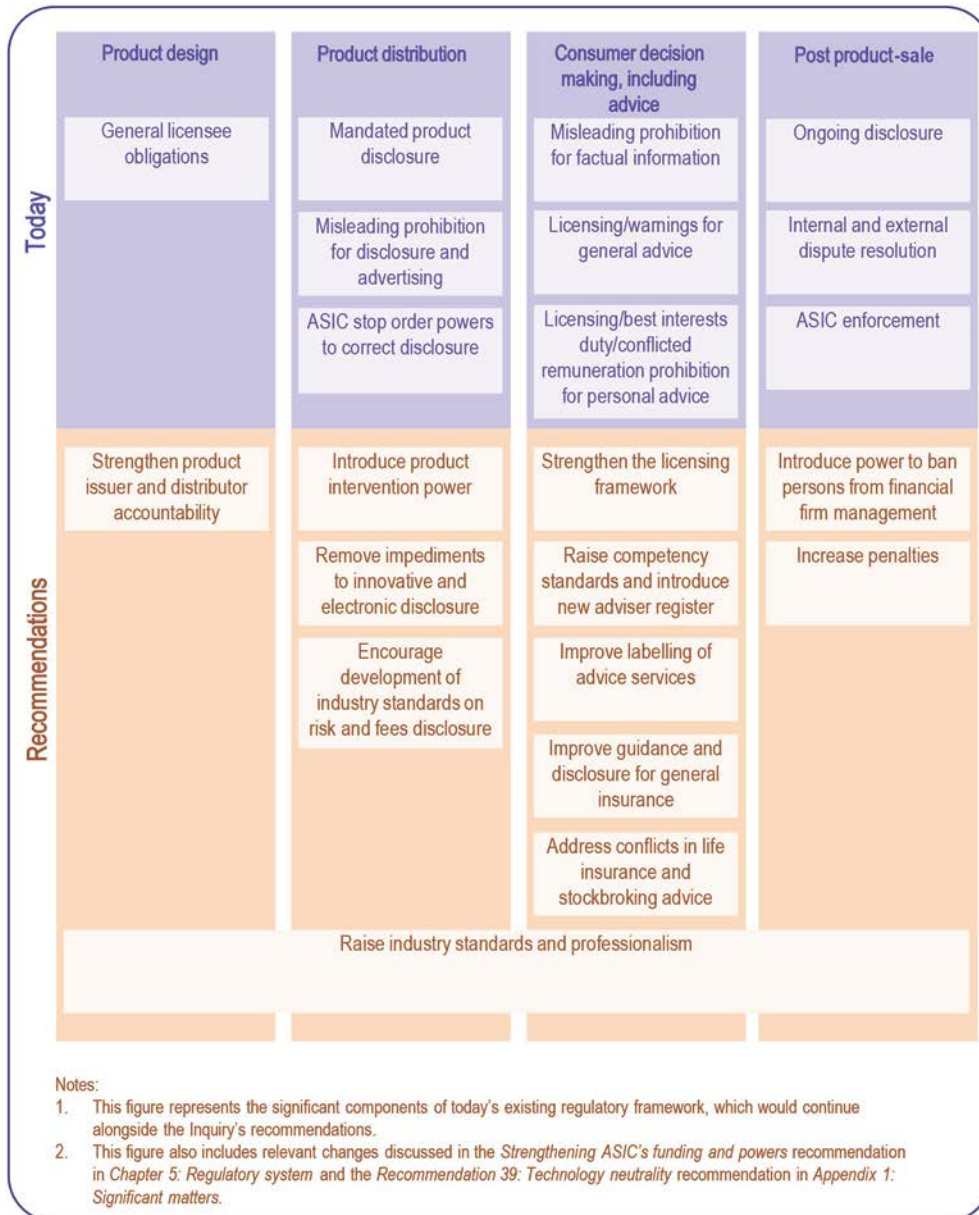
3. Facilitate innovative forms of disclosure, including by encouraging industry to further use technology. Although the disclosure regime has evolved to reduce complexity over the last decade, consumer behavioural biases and commercial disincentives limit its effectiveness. The Inquiry sees scope to promote efficient communication of information to consumers in a way that responds to technological advances and changing consumer preferences (see also *Recommendation 39: Technology neutrality*). Risk and fee disclosure remains variable and consumer understanding low. In addition, industry should develop consistent standards to improve disclosure of risk and fees.

The Senate Economics References Committee's report on ASIC's performance was released shortly before publication of the Inquiry's Interim Report. The Inquiry indicated that it would consider the Senate Committee's recommendations in its final deliberations. In particular, the Senate Committee recommended that this Inquiry consider the adequacy of Australia's conduct and disclosure approach to the regulation of financial firms. The Inquiry has considered issues raised by the Senate Committee, and makes recommendations in this chapter, including in relation to product issuer and distributor accountability, product intervention power, adviser competency and register, and banning powers.¹

¹ The Senate Economics References Committee 2014, *Performance of the Australian Securities and Investments Commission*, Canberra, page 393, 443.

Figure 12 illustrates the Inquiry’s recommendations in the context of a typical product life cycle.

Figure 12: Recommendations to improve consumer outcomes



Principles

In developing recommendations to improve consumer outcomes in the financial system, the Inquiry has been guided by the objective of ensuring the fair treatment of participants, particularly consumers of financial products and services. The principles underlying this objective are:

- A fair, well-functioning financial system allows consumers to take on risk to make a return. Inevitably, this means consumers will incur gains and losses from market movements.
- Consumers should bear responsibility for their financial decisions. To assist them in doing this:
 - Consumers should receive fair treatment from financial firms.
 - Consumers should have access to competent, good-quality, customer-focused advice and guidance.
 - Information provided to consumers should be accessible, engaging and understandable.
 - Financial literacy strategies should be an important element of the consumer framework.
- Product issuers and distributors should take responsibility for the design, targeting and distribution of financial products.
- ASIC should be proactive in its supervision and enforcement to reduce the risk of significant detriment to consumers.
- Consumers should have access to timely and low-cost dispute resolution.

Conclusion

The Inquiry considers implementing the following package of recommendations would enhance the fair treatment of consumers. It would strengthen the accountability of product issuers and distributors, reduce the risk of significant consumer detriment from unfair treatment, and encourage a customer-focused culture in financial firms. Implementing these recommendations would strengthen consumer confidence and trust in the system and improve system efficiency.

Strengthen product issuer and distributor accountability

Recommendation 21

Introduce a targeted and principles-based product design and distribution obligation.

Description

Government should amend the law to introduce a principles-based product design and distribution obligation.² The obligation would require product issuers and distributors to consider a range of factors when designing products and distribution strategies. In addition to commercial considerations, issuers and distributors should consider the type of consumer whose financial needs would be addressed by buying the product and the channel best suited to distributing the product. Industry should supplement this principles-based obligation with appropriate standards for different product classes.

The obligation would cover:

- **During product design**, product issuers should identify target and non-target markets, taking into account the product's intended risk/return profile and other characteristics. Where the nature of the product warrants it, issuers should stress-test the product to assess how consumers may be affected in different circumstances. They should also consumer-test products to make key features clear and easy to understand.
- **During the product distribution process**, issuers should agree with distributors on how a product should be distributed to consumers. Where applicable, distributors should have controls in place to act in accordance with the issuer's expectations for distribution to target markets.
- **After the sale of a product**, the issuer and distributor should periodically review whether the product still meets the needs of the target market and whether its risk profile is consistent with its distribution. The results of this review should inform future product design and distribution processes. This kind of review would not be required for closed products.³

2 This obligation would not apply to credit products regulated under the *National Consumer Credit Protection Act 2009*, because the responsible lending obligation currently requires assessment of suitability on an individual basis.

3 Closed products are those not accepting new customers or funds, of which legacy products are a subset.

These requirements would be scalable, depending on the nature of the product. Compliance with this obligation should be straightforward for simple products that are likely to be suitable for most consumers. For example, simple, low-risk products such as basic banking products would not require extensive consideration and may be treated as a class, with a standard approach to their design and distribution.

A serious breach of this obligation should be subject to a significant penalty.

Objectives

- Reduce the number of consumers buying products that do not match their needs, and reduce consequent significant consumer detriment.
- Promote fair treatment of consumers by firms that design and distribute financial products.
- Promote efficiency and limit or avoid the future need for more prescriptive regulation.
- Build confidence and trust in the financial system.

Discussion

Problem the recommendation seeks to address

The existing framework relies heavily on disclosure, financial advice and financial literacy. However, disclosure can be ineffective for a number of reasons, including consumer disengagement, complexity of documents and products, behavioural biases, misaligned interests and low financial literacy.⁴ Many consumers do not seek advice, and those who do may receive poor-quality advice. Many products are also distributed directly to consumers.

Such issues have contributed to consumer detriment from financial investment failures, such as Storm Financial, Opes Prime, Westpoint, agribusiness schemes and unlisted debentures, which have affected more than 80,000 consumers. Losses from these failures totalled more than \$5 billion, or \$4 billion after compensation and liquidator recoveries.⁵ Although these losses have a number of contributing causes, poor product design and distribution practices that disregarded consumer behavioural biases and information imbalances played a significant role. A recent independent report on improving consumer compensation arrangements identified scope to make

4 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 3-57.

5 These figures include losses involving the more substantive cases of financial investment failures in the last 10 years, such as Storm Financial, Opes Prime, Westpoint, Great Southern, Timbercorp and Banksia Securities.

Financial System Inquiry — Final report

product issuers more responsible for product distribution.⁶ Although FOFA has made significant changes to reduce incentives for inappropriate distribution where personal advice is provided, more can be done during the product design phase to complement these measures.

The current quality of product design and distribution controls is variable. ASIC's report on *Regulating Complex Products* observed that some consumers acquire structured products that are riskier than they realise.⁷ For example:

- Insufficient information provided in the disclosure documents, advertising and seminars relating to over-the-counter contracts for difference (CFD) made it difficult for retail consumers to make informed investment decisions.
- Some firms distributing hybrid securities included sales information in addition to, or inconsistent with, the information in the prospectus. This information tended to emphasise high yield while downplaying risk.

The Inquiry is also concerned that certain less complex add-on insurance products may not meet the needs of some consumers. For example, an ASIC report revealed Consumer Credit Insurance (CCI) products being bought by consumers whose situation made them ineligible to claim under the policy.⁸ The Financial Ombudsman Service (FOS) found that 11 per cent of claims on CCI products were declined, compared with 3 per cent of all personal general insurance claims.⁹

A number of recent high-profile ASIC enforceable undertakings (EUs) demonstrate some firms had serious compliance issues in providing personal advice and internal controls.¹⁰ Although these examples raise potential breaches of the personal advice regime and occurred before the significant FOFA changes, they also demonstrate weaknesses in processes for, and controls on, product distribution to consumers that are not limited to the provision of personal advice.

The financial services industry has already attempted to address this problem through broader risk management processes and specific initiatives. For example, the

6 Commonwealth of Australia 2012, *The Treasury, Compensation arrangements for consumers of financial services*, report prepared by R St John, Canberra, pages 149–150.

7 Australian Securities and Investments Commission (ASIC) 2014, *Report 384: Regulating complex products*, ASIC, Sydney, page 4.

8 Australian Securities and Investments Commission (ASIC) 2011, *Report 256: Consumer credit insurance: A review of sales practices by authorised deposit taking institutions*, ASIC, Sydney, pages 22–23.

9 Financial Ombudsman Service (FOS) 2014, *General Insurance Code of Practice: Overview of the year 2012/2013*, FOS, Melbourne, page 51.

10 For example, Australian Securities and Investments Commission (ASIC) 2011, Enforceable Undertaking (EU) with Commonwealth Financial Planning Limited, 25 October; ASIC 2011, EU with UBS Wealth Management Australia Ltd, 17 March; ASIC 2013, EU with Macquarie Equities Ltd, 29 January.

Australian Financial Markets Association (AFMA) has developed product approval principles for retail structured finance products. However, these do not cover all issuers and distributors, and, in any event, are not enforceable.¹¹

This recommendation takes into account the Senate Economics References Committee's report on ASIC's performance. The Senate Committee suggested that urgent attention should be given to providing ASIC with the necessary toolkit to prevent consumer detriment by subjecting the product issuer to more positive obligations in regard to the suitability of its product.¹²

Rationale

To improve consumer outcomes, the framework should promote the targeting of products to those consumers who would benefit from them. This would reduce the incidence of consumers buying products that do not match their needs, building consumer confidence and trust in the financial system. It would also benefit individual firms by improving customer relationships.

Options considered

The Inquiry raised two options in its Interim Report to reduce the number of consumers buying products that do not match their needs:

1. **Recommended:** Introduce a targeted product design and distribution obligation.
2. Introduce individual appropriateness test at point of sale for complex products.

In response to the Interim Report, submissions also suggested the following additional option:

3. Implement a new obligation through a fully self-regulatory approach by setting expectations for industry and monitoring their progress, with regulatory follow-up if progress is not made.

Option costs and benefits

Introduce a targeted product design and distribution obligation

Increasing the accountability of product issuers and distributors in this way would boost consumer confidence and trust in the system, and is supported in submissions

11 Australian Financial Markets Association (AFMA) 2012, *Principles relating to product approval – retail structured financial products*, AFMA, Sydney.

12 The Senate Economics References Committee 2014, *Performance of the Australian Securities and Investments Commission*, Commonwealth of Australia, Canberra, pages 442–443.

Financial System Inquiry — Final report

by many consumer groups and financial advice groups. However, industry submissions note that many firms already have sophisticated controls in place, and regulatory intervention would increase product costs or decrease product offerings for consumers.¹³ Submissions from issuers, distributors and industry groups also raise concerns about the difficulty for product issuers in determining the suitability of products and the additional compliance cost involved with introducing the new obligation. Firms believe their processes would need to be reviewed even if they already have controls in place.

However, the Inquiry notes the proposed obligation is likely to have substantial benefits for consumers. As discussed earlier, in conjunction with other measures, a product issuer and distributor obligation could reduce the incidence of cases such as:

- Storm Financial, where margin lending products did not suit consumer risk profiles, such as those approaching retirement who could only cover significant losses by selling the family home. Close to 2,800 consumers faced around \$500 million net losses.¹⁴
- Opes Prime, where complex securities lending arrangements were not understood by consumers. As a result, hundreds of clients, many of whom were retail consumers, faced close to \$400 million net losses.¹⁵

The Inquiry considers that industry concerns about implementation costs can be dealt with by ensuring the obligation builds on good practice, is principles-based and is applied on a scaled basis, allowing scope for firms to adapt their existing practices. Thus, the new obligation would impose minimal costs on firms with existing good practices. Some incremental costs for industry may include client categorisation, record keeping, updating documentation and staff training, as well as monitoring changes in the external environment. In addition, the regulator would require additional resources to establish initial guidance and monitor compliance.

Some stakeholders suggest that a new obligation of this kind should be limited to the design and distribution of complex products. Although many of the recent cases of concern involve distribution of complex products to retail clients, examples of concern have also included distribution of less complex products such as add-on insurance and debentures. Recent EUs have raised concerns with the quality of distribution plans for credit cards.¹⁶ The Inquiry's view is that the obligation should not be restricted. As a

13 Australian Bankers' Association 2014, Second round submission to the Financial System Inquiry, page 50.

14 Australian Securities and Investments Commission 2014, First round submission to the Financial System Inquiry, page 191.

15 Australian Securities and Investments Commission 2013, Verdict in Opes Prime director trial, media release, 6 September.

16 Australian Securities and Investments Commission 2012, Enforceable Undertaking with Commonwealth Bank of Australia, 6 March.

matter of principle, the proposed obligation should be universal in its nature and scalable in line with the nature of the product.

This option would deliver benefits to industry, including strengthening internal risk management for product design, which may mitigate future problems, as well as signalling a higher level of customer focus. This approach should also avoid new, more complex and interventionist regulation in the future, promoting efficiency in the financial system overall.

This recommendation aligns with policy objectives in peer jurisdictions; however, the Inquiry has taken a principles-based approach that is less prescriptive. The European Union and the United Kingdom have introduced regulated product governance arrangements, and the International Organization of Securities Commissions has suggested that issuers evaluate whether their general distribution strategy is appropriate for the target market, particularly for structured products.¹⁷ The United Kingdom recently assessed compliance with the new product governance obligation, suggesting that although firms' processes and procedures are of variable quality, the obligation is playing a positive role in focusing firms on consumer needs.¹⁸

Introduce individual appropriateness test at point of sale

In the European Union, an individual product appropriateness test is being introduced for product issuers and distributors at point of sale.¹⁹ An appropriateness test requires the assessment of some of an individual's personal circumstances before making the product available to them. In Japan, Hong Kong and Singapore, intermediaries are required to assess consumers' knowledge and experience of certain complex products before providing services to them.²⁰ In the United States, the Financial Industry Regulatory Authority has introduced heightened supervision expectations on issuers and distributors for complex products.²¹

An individual appropriateness test, where no personal advice is provided, would introduce significant costs for issuers and distributors due to necessary changes to the sales process. Appropriateness tests are also open to manipulation. The Inquiry

17 European Securities and Markets Authority (ESMA) 2014, *Consultation Paper: MIFID/MiFIR*, ESMA, Paris, page 39; Financial Conduct Authority (FCA), *Regulatory Guide: The responsibilities of providers and distributors for the fair treatment of consumers*, FCA, London; International Organization of Securities Commissions (IOSCO) 2013, *Report FR 14/13 Regulation of retail structured products*, IOSCO, Madrid, pages 43,52.

18 Financial Services Authority (now the Financial Conduct Authority) (FCA) 2012, *Retail product development and governance – structured product review*, FCA, London, page 11.

19 European Securities and Markets Authority (ESMA) 2014, *Consultation Paper: MIFID/MiFIR*, ESMA, Paris, page 136.

20 Australian Securities and Investments Commission (ASIC) 2014, *Report 384: Regulating complex products*, ASIC, Sydney, page 41.

21 Financial Industry Regulatory Authority (FINRA) 2012, *Regulatory notice 12-03: Heightened supervision for complex products*, FINRA, Washington DC, pages 5–6.

Financial System Inquiry — Final report

believes that the objective can be achieved by taking a principles-based approach to product design and distribution that is less prescriptive.

Implement new obligation through a fully self-regulatory approach

This option would build on the recent work of AFMA, relying on the financial services industry to monitor how standards are applied and take relevant disciplinary action if required. However, recent experience with industry self-regulation in the financial sector suggests that improving the design and distribution of products for consumers would not be achieved by self-regulation alone.

The Inquiry considers that past industry-led standards have not been sufficient by themselves to address serious conduct issues; for example, managing conflicts in financial advice driven by remuneration. Despite efforts over many years, the financial advice industry failed to improve financial advisers' conduct, leaving it unable to prevent or reduce the effect of recent serious cases of poor advice.

Although AFMA standards on product approval practices are valuable, they do not cover the whole industry and are not subject to substantive monitoring and enforcement. Self-regulation alone would also fail to underscore the importance of this recommendation to improve consumer outcomes.

Conclusion

Product issuers and distributors are best placed to understand the features of a product and its appropriate target market. Introducing a targeted design and distribution obligation for all products would decrease the number of consumers buying products that do not meet their needs, and would make the industry more customer-focused in product design. Therefore, the Inquiry recommends introducing a principles-based regulatory obligation that enables industry to develop standards of practice tailored to product classes.

The Inquiry recognises that some firms have already made significant progress in designing products for and distributing products to suitable target markets. For firms that are already designing products and distribution strategies in this way, the new obligation is not likely to have a significant effect. The Inquiry considers that this best-practice approach taken by some firms should become standard practice.

Implementation considerations

This recommendation should not limit the kinds of products that could be developed and issued. The Inquiry supports the role of innovation and its benefits to consumers. The new obligation would help target innovative products to consumers whose needs align with product features. This may mean certain products are not marketed to certain kinds of retail consumers, or are not marketed to consumers unless certain conditions are met — an approach consistent with existing good practice.

Chapter 4: Consumer outcomes

This recommendation should also be considered in conjunction with other recommendations in this report, particularly those in *Chapter 5: Regulatory system*. Implementing this recommendation would require adequate regulator capabilities to review financial firms' internal controls and to understand the relevant product markets and consumer behavioural biases.

Circumstances beyond those reasonably foreseeable at the time would not be expected to be taken into consideration by issuers and distributors.

Introduce product intervention power

Recommendation 22

Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.

Description

Government should amend the law to provide ASIC with a product intervention power. ASIC should be equipped to take a more proactive approach to reducing the risk of significant detriment to consumers with a new power to allow for more timely and targeted intervention. This power should be used as a last resort or pre-emptive measure where there is risk of significant detriment to a class of consumers. This power would enable intervention without a demonstrated or suspected breach of the law. Given the potential significant commercial impact of this power, the regulator should be held to a high level of accountability for its use.

This power would allow the regulator to intervene to require or impose:

- Amendments to marketing and disclosure materials.
- Warnings to consumers, and labelling or terminology changes.
- Distribution restrictions.
- Product banning.

This power is not intended to address problems with pricing of retail financial products, where consumers might be paying more than expected for a particular product or where a large number of consumers have incurred a small detriment.

The power would be limited to temporary intervention for 12 months. The temporary intervention could be extended by Government if more time was needed either by industry to change its relevant practices or for Government to implement permanent reform. The power could be used against an individual firm or class of firms in relation to a product or class of products. The power would be subject to a judicial review mechanism.

ASIC would be required to consult with the Australian Prudential Regulation Authority (APRA) prior to using this power when it may affect an APRA-regulated body. Government should review the use of this power after five years.

The Inquiry's view is that providing ASIC with this new power complements the need for a proactive market-based regulator. The efficacy of this power depends on a strong, independent and accountable regulator. As part of its overall assessment of ASIC's performance against its mandate, the proposed Financial Regulator Assessment Board should assess the use of this new power. (See *Chapter 5: Regulatory system* for a range of complementary recommendations.)

Objectives

- Reduce significant detriment arising from consumers buying financial products they do not understand.
- Limit or avoid the future need for more prescriptive regulation.
- Build consumer confidence and trust in the financial system and, in turn, improve efficiency through increased consumer engagement and participation.

Discussion

Problem the recommendation seeks to address

Currently, ASIC can only take action to rectify consumer detriment after a breach or suspected breach of the law by a firm. Further, ASIC can only take enforcement action against conduct causing consumer detriment on a firm-by-firm basis, even where the problem is industry-wide.

Australia has had cases of significant consumer detriment where ASIC had exhausted its current regulatory toolkit and where there was no clear basis to take enforcement action. These include:

- Mortgage managed investment schemes (MISs), where close to 100 were frozen in the market downturn during the global financial crisis. More than 4,000 consumers received hardship relief, indicating that many did not expect an investment of this type to be illiquid.²²
- Unlisted debenture investments, such as Banksia Securities, where many consumers thought the products they bought were like bank term deposits. More than 1,500 consumers have lost more than \$100 million after recoveries to date.²³ Prior to the collapses, ASIC took action to stop a number of individual pieces of

22 Parliamentary Joint Committee on Corporations and Financial Services 2011, *Statutory oversight of the Australian Securities and Investments Commission*, 28 February, Commonwealth of Australia, Canberra, page 10.

23 McGrathNicol 2012, *Banksia Securities Limited Cherry Fund Limited (Receivers and Managers appointed to both companies): Receivers and Managers' Report to debenture holders*, Sydney, page 14; McGrathNicol 2014, *Banksia Securities Limited (Receivers and Managers appointed): Circular to debenture holders*, Sydney, page 1.

Financial System Inquiry — Final report

marketing, but that did not correct consumers' overall impressions about the level of risk involved.

In both cases, ASIC responded to the emerging risk of significant consumer detriment by providing guidance on the nature of disclosure that should accompany these products. However, ASIC did not have power to impose such disclosure requirements, instead seeking to create an expectation on firms to provide clearer disclosure that outlined the risk and central features of the products.

There have also been cases where ASIC lacked a broad toolkit to respond effectively and in a timely way to an emerging risk of significant consumer detriment. For example, the following cases involving leveraged investment strategies that exacerbated the loss for many consumers:

- Agribusiness schemes, where the product did not perform in the way that consumers were led to believe, including schemes relying on ongoing sales to fund their operations. Many consumers did not understand the potential risk of borrowing to invest in these products. In total, more than 65,000 consumers invested and lost close to \$3 billion.
- Financial collapses that involved poor distribution practices, such as Storm Financial and Opes Prime. More than 3,000 consumers lost more than \$1.4 billion, of which around half was recovered.²⁴

Although these cases have a number of contributing causes, a strong, independent and accountable ASIC, as recommended in *Chapter 5: Regulatory system*, in combination with early intervention using the proposed power, would likely reduce consumer losses in similar situations.

Changes in technology mean that consumers have increasing access to complex products, which can involve complicated structures and heightened risk. These products may be difficult for consumers to understand, testing the limits of the disclosure-based regulatory regime. For example, some structured products have a high degree of risk, but are labelled, described and promoted in a way that suggests they have lower risk.²⁵ In such cases, consumers may still not understand the risk/return trade-off or the central features of the financial product or strategy, even where they are accurately disclosed.

Although complexity does not necessarily correlate to higher risk, complex features make it particularly difficult for consumers to assess the risk and appropriate pricing

24 Australian Securities and Investments Commission (ASIC) 2014, First round submission to the Financial System Inquiry, page 191; ASIC 2013, Verdict in Opes Prime director trial, media release, 6 September.

25 Australian Securities and Investments Commission (ASIC) 2013, *Report 340: 'Capital protected' and 'capital guaranteed' retail structured products*, ASIC, Sydney, page 8.

of higher-risk products. ASIC found that 71 per cent of survey respondents, including industry participants, consumers and financial literacy specialists, believe that Australian consumers do not understand the risk involved with complex products.²⁶ Also, complex products are particularly influenced by behavioural biases: people respond automatically and unconsciously to try to simplify the decision-making process, leading to poor financial decisions.²⁷

That said, the risk of consumer confusion about risk and features is not limited to complex products. Past case studies involving margin loans, mortgage schemes and debentures indicate consumers may also misunderstand less complex products and their core features and risk.²⁸ Many consumers find information imbalances or behavioural biases hard to overcome. Some current product distribution strategies also hamper understanding. For example, investors in CFDs may rely disproportionately on issuer marketing materials, which may not provide a sufficient basis for making an informed decision.²⁹ (See *Recommendation 21: Strengthen product issuer and distributor accountability*.)

This recommendation takes into account the Senate Economics References Committee's report on ASIC's performance. The Senate Committee suggested that urgent attention should be given to providing ASIC with the necessary toolkit to prevent consumer detriment through allowing ASIC to intervene and prohibit the issue of certain products in retail markets.³⁰

Rationale

The Inquiry believes that targeted early intervention would be more effective in reducing harm to consumers than waiting until detriment has occurred. The regulator should be able to be proactive in its supervision and enforcement. Significant consumer detriment could be reduced if ASIC had the power to stop a product from being sold or, where the product had already been sold, to prevent the problem from affecting a larger group of consumers.

26 Australian Securities and Investments Commission (ASIC) 2013, *ASIC Stakeholder survey*, ASIC, Sydney, page 28. Survey conducted by Susan Bell Research, covering 1,468 stakeholders.

27 Kahneman, D 2011, *Thinking Fast and Slow*, Penguin Books Ltd, London, page 224.

28 For example, Parliamentary Joint Committee on Corporations and Financial Services 2009, *Inquiry into financial products and services in Australia*, Canberra, Commonwealth of Australia, pages 28–30, 56–58; Australian Securities and Investments Commission (ASIC) 2012, *Regulation impact statement: Mortgage schemes: Strengthening disclosure under RG 45*, ASIC, Sydney, pages 12–13.

29 Australian Securities and Investments Commission (ASIC) 2010, *Report 205: Contracts for difference and retail investors*, ASIC, Sydney, page 8.

30 Senate Economics References Committee 2014, *Performance of the Australian Securities and Investments Commission*, Canberra, Commonwealth of Australia, pages 442–443.

Options considered

The Inquiry raised two options in its Interim Report to reduce consumer detriment:

1. **Recommended:** Introduce a product intervention power.
2. Introduce default products for a range of basic financial needs; for example, deposits, home and contents insurance and basic investments.

In response to the Interim Report, submissions also suggested the following additional option:

3. Prohibit distribution of certain classes of non-mainstream products to retail consumers.

Option costs and benefits

Introduce product intervention power

Most consumer group submissions support a broad intervention power.³¹ The banking industry supports the ability to ban products temporarily where detriment to consumers is significantly likely, but not to prescribe terminology or restrict product features, due to the potential constraints on product innovation.³² However, many industry stakeholders do not support changes of this nature, citing concerns about misuse of the power obstructing legitimate business opportunities. Others believe such a power needs court or parliamentary oversight. They question whether ASIC's cultural and skills mix is sufficient to carry out the responsibilities associated with such a power. On the other hand, some believe additional powers "... would allow ASIC to react quickly to market developments".³³

Some stakeholders believe the nature of the powers would create uncertainty, constrain innovation, detract from consumer accountability and introduce costs that may be borne by consumers. They are also concerned about the reputational cost if the new power is used. The Inquiry considers these concerns can be addressed by the design and implementation of the power. Specifically:

- If the power is used effectively, it should not significantly affect innovation. The power is expected to be used infrequently and as a last resort or pre-emptive measure. In addition, this power is not intended to be used for pre-approval of

31 For example, Superannuation Consumers' Centre 2014, Second round submission to the Financial System Inquiry, pages 14–15.

32 Australian Bankers' Association 2014, Second round submission to the Financial System Inquiry, page 51.

33 Deloitte Access Economics 2014, Second round submission to the Financial System Inquiry, page 58.

products as this is likely to result in moral hazard: the perception that no regulator intervention implies a low-risk product.

- This power is not intended to alleviate consumers from bearing responsibility for their financial decisions. This would be made clear when the power is implemented.
- Firms with robust product design and distribution practices should not face additional regulatory costs as the focus would be on products being distributed to consumers who do not understand the central features of the products, such as risk. ASIC engagement with potentially affected firms would allow these firms to change their practices before any use of the power, thereby limiting public reputational damage.
- The regulator would be accountable for the use of its power, and it would be subject to post-implementation review. ASIC would be expected to engage with potentially affected firms and to consult with Council of Financial Regulators colleagues before any use of the power, including consulting with APRA where prudentially regulated firms may be affected.

This recommendation would be consistent with policy responses in most peer jurisdictions, which have taken an increasingly proactive regulatory stance. In 2012, the United Kingdom introduced product intervention rules, and since then it has used them to restrict the distribution of contingent convertible instruments.³⁴ Similar changes have been reflected in Europe through amendments to the Markets in Financial Instruments Directive, with a view to increasing consumer protection.³⁵ The US Consumer Financial Protection Bureau has the power to declare certain practices unfair, deceptive or abusive.³⁶ However, the Inquiry believes that the same outcome can be achieved in Australia with a less extensive power than is in place in these jurisdictions.

Many cases of financial firm failure include situations where consumers have failed to understand the risk/return trade-off involved in a product, even if disclosure and advice were compliant. Examples of cases discussed earlier have affected a significant number of Australians, and involved large uncompensated losses. Although it is hard to quantify the dollar value of the consumer detriment the power might prevent, the Inquiry believes that the benefits to consumers would be substantial.

34 Financial Conduct Authority (FCA) 2014, *Restrictions in relation to the retail distribution of contingent convertible instruments*, FCA, London.

35 European Securities and Markets Authority (ESMA) 2014, *Consultation Paper: MIFID/MiFIR*, ESMA, Paris, page 166.

36 Dodd-Frank Wall Street Reform and Consumer Protection Act 2010, USA, s1031.

Financial System Inquiry — Final report

In addition, as discussed in *Recommendation 21: Strengthen product issuer and distributor accountability* in this chapter, consumer confidence and trust in the financial system can be improved by shifting to a more proactive regulator.

Introduce default products

Introducing default products would involve significant new powers and require considerable resources and skilled personnel. Although some areas may need default products, such as superannuation, where consumers are compelled to participate, the Inquiry does not believe this rationale extends to other product types. Widening the pool of default products may risk significantly limiting innovation and reducing competition.

Prohibit distribution of products

Some international jurisdictions have prohibited the distribution of certain classes of product to retail consumers. For example, in the United Kingdom, non-mainstream investment products are prohibited from being distributed to retail consumers.³⁷

Although such measures may reduce the risk of detriment, they take a broad approach and remove choice across a range of products for consumers who may understand the risk involved. For this reason, the Inquiry does not recommend them.

Conclusion

The Inquiry believes it is important to reduce consumer detriment and rebuild consumer confidence and trust in the financial system in the longer term. A more proactive approach to improving retail consumer outcomes underscores the importance of financial firms treating consumers fairly. This is a significant new power that is consistent with having a proactive regulator. The power should be used carefully, and ASIC should be accountable for its use as discussed in *Chapter 5: Regulatory system*.

Implementation considerations

Accountability would be an important part of the application of this new power. ASIC would be expected to issue general policy (after public consultation) describing when the power may be used, the process of engagement with affected parties, consultation with other regulators before the use of the power, transparency in its use and public reporting of the review of each use of this power. An affected product issuer or distributor, or class of affected firms, should be able to seek judicial review on the use of the power.

Given the significance of this new kind of power, Government should review its use after five years.

³⁷ Financial Conduct Authority (FCA) 2013, *PS13/3: Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes*, FCA, London.

Facilitate innovative disclosure

Recommendation 23

Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.

Description

Government should amend the law to remove regulatory impediments to innovative communication of product disclosure information, such as the use of online communication tools, new media, self-assessment tools and videos. This change should occur in two phases:

1. By ASIC giving individual exemptions from the law through its current pilot project to allow innovative communication of mandated product disclosure information.
2. By implementing a broader exemption through legislation, taking into account the effectiveness of innovative disclosure under ASIC's pilot project.

Industry should develop standards for disclosing risk and fees, and, if significant progress is not made within a short time frame, Government should consider a regulatory approach.

Objectives

- Promote more engaging and effective communication with consumers to increase consumer understanding and facilitate better decision making.
- Reduce the number of consumers buying products that do not match their needs.
- Promote efficiency, including competition, by better informing consumers.

Discussion

Problems the recommendation seeks to address

Product disclosure

Mandated product disclosure requirements, which set form and content requirements, are impeding issuers from developing innovative approaches to communicating disclosure information.³⁸ With technological developments, such as those enabling online financial services, consumer expectations have changed, but the current regime inhibits the ability of firms to meet these expectations.

The Inquiry supports the need for mandated product disclosure, which is necessary to inform the market and to support issuers and consumers in setting out the terms of their contract. However, the Inquiry sees scope to provide issuers with more flexibility to communicate mandated disclosure to better engage and inform consumers.

Consumers can more effectively use information that is accessible, engaging and understandable. Research shows that presenting financial product information in shorter disclosure documents that are better signposted, and using plain English and graphics, can improve consumer understanding.³⁹ Although there has been limited research on the benefits of new media compared with paper-based disclosure, new media offers opportunities for more engaging communication.

An ASIC pilot project is underway to test innovative approaches to disclosure. Issuers in this pilot will provide consumers with a key facts sheet and a self-assessment tool using a variety of electronic media, including video, audio and interactive presentations. ASIC will provide individual relief necessary to facilitate the pilot.

Risk and fee disclosure

With the exception of the new standard risk measure in the MySuper product dashboard, the law generally does not provide detailed requirements on how to disclose risk. Yet evidence shows that consumers frequently misunderstand risk relating to financial products. ASIC found that 45 per cent of survey respondents, including industry participants, consumers and financial literacy specialists, believe consumers do not understand that higher reward often means higher risk, and 71 per cent believe that consumers fail to fully understand the risk involved in complex

38 A number of legislative provisions require issuers to provide documents and in some cases prescribe the format; for example, the *Corporations Regulations 2001* for superannuation and simple managed investment products, the *Corporations Act 2001* for prospectus requirements, and the *National Consumer Credit Protection Act 2009* and the *National Consumer Credit Protection Regulations 2010* for credit contracts and consumer leases.

39 For example, Susan Bell Research 2008, *The provision of consumer research regarding financial product disclosure documents: Research report for the Financial Services Working Group*, Susan Bell Research, Sydney.

products.⁴⁰ Behavioural economists highlight that individuals are prone to making systematic errors in decisions that involve assessing risk and uncertainty, such as when making insurance or investment decisions.⁴¹

The law mandates standardised communication of fees for superannuation and simple MISs. Despite these more prescriptive fee disclosure provisions, ASIC has recently reported varied compliance practices and is consulting on clarifications to the law. However, even after these clarifications of current law, aspects of fee disclosure would remain open to industry to standardise further where the law does not set specific requirements. These areas include:

- Improving treatment of buy–sell spreads in unit prices.
- Reducing differences in fee disclosure between superannuation and simple MISs.
- Improving the provision of fee information by issuers of underlying investment entities.

Conclusion

The Inquiry considers that innovative disclosure can improve consumer engagement and understanding, and that industry should pursue innovative disclosure and alternative forms of communication. The Inquiry endorses the ASIC pilot project and encourages industry to continue to engage with ASIC about forms of innovative disclosure.

The Inquiry is aware that commercial factors can work against creating more innovative disclosure. Although removing impediments may or may not provide sufficient incentive for industry incumbents to innovate, it may allow new entrants to drive different forms of disclosure.

The results from ASIC’s pilot should be considered when drafting new laws to facilitate innovative disclosure, including the findings from consumer testing within the pilot. Consideration should also be given to domestic and international research on the presentation of mandated information.

The Inquiry also considers improved disclosure of risk would assist consumers to make more informed decisions about financial products. Improving consistency of fee presentation would enhance allocative efficiency; for example, by promoting fee-based competition in superannuation.

40 Australian Securities and Investments Commission (ASIC) 2013, *ASIC Stakeholder Survey*, ASIC, Sydney, page 28. Survey conducted by Susan Bell Research, covering 1,468 stakeholders.

41 Financial Conduct Authority (FCA) 2013, *Occasional Paper No.1, Applying behavioural economics at the Financial Conduct Authority*, FCA, London, page 5.

Financial System Inquiry — Final report

The Inquiry recommends a self-regulatory, flexible approach to improving communication of risk and fees, allowing tailoring for different classes of products and avoiding prescriptive regulation, which would involve higher compliance costs. Industry should build on existing measures to improve consumer understanding of risk by including risk measures for investment products; for example, simple and non-simple MISs, securities and structured products. Industry should also consider examples of risk measures used in Europe and Canada. In developing risk measures, industry should consider:

- Whether a risk measure should be applied broadly across all classes of product.
- Whether there are more effective alternatives to risk measures, such as:
 - Disclosure on relative expected or promised return against a well-regarded benchmark like the official cash rate.
 - Tools that assist consumers to understand how products would be likely to perform in different market conditions.
 - Prominent warnings about whether a product is leveraged and what this means for consumers if there is a serious market downturn.

Proposed measures should be consumer-tested to maximise their effectiveness.

Align the interests of financial firms and consumers

Recommendation 24

Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.

Description

Better align the interests of financial firms with those of consumers by:

- Industry raising standards of conduct and levels of professionalism to build confidence and trust in the financial system.
- Government amending the law to provide ASIC with an enhanced power to ban individuals, including officers and those involved in managing financial firms, from managing a financial firm. This would enhance adviser and management accountability.
- Government amending the law to require that an upfront commission for life insurance advice is not greater than ongoing commissions. This would reduce incentives for churning and improve the quality of advice on life insurance.
- ASIC reviewing the effect of current stockbroking remuneration structures on the quality of consumer outcomes. If this review raises significant concerns, ASIC should advise Government on the need to remove the sector's exemption from the ban on conflicted remuneration.

Objectives

- Improve the culture of financial firms and build consumer trust in those firms.
- Align remuneration structures with a customer-focused culture.
- Promote efficiency in the financial advice sector through increased consumer participation and engagement.

Discussion

Problems the recommendation seeks to address

Poor standards of conduct and professionalism

Recent cases of poor financial services provision raise serious concerns with the culture of firms and their apparent lack of customer focus. Research in 2009 suggested that financial firms may not be implementing systems and procedures within their organisations that promote ethical culture and integrate governance, risk management and compliance frameworks.⁴² In 2011–12, approximately 94 per cent of ASIC’s banning orders involved significant integrity issues, where the alleged conduct would breach professional and ethical standards and/or the conduct provisions in the *Corporations Act 2001*.⁴³ The remaining 6 per cent of cases involved competency issues.

The Inquiry considers that cases of consumer detriment and poor advice reflect organisational cultures that do not focus on consumer interests. Such cultures promote short-term commercial outcomes over longer-term customer relationships. This has contributed to a lack of consumer confidence and trust in the system. In research undertaken by Roy Morgan, only 28 per cent of participants gave financial planners ‘high’ or ‘very high’ ratings for ethics and honesty, and trust in bank managers was held by just 43 per cent of participants.⁴⁴ In addition, ASIC found only 33 per cent of stakeholders agreed that financial firms operate with integrity.⁴⁵

Banning power

ASIC has observed phoenix activity in financial firms, where senior people from a financial firm with poor operating practices may establish a new business or move to an alternative firm.⁴⁶ Currently, ASIC can prevent a person from providing financial services, but cannot prevent them from managing a financial firm. Nor can ASIC remove individuals involved in managing a firm that may have a culture of non-compliance.

Life insurance

In light of recent evidence, the Inquiry is concerned about high upfront commissions for life insurance advisers. This has been a longstanding industry practice reflecting

42 Smith, J 2009, *Professionalism and Ethics in Financial Planning*, Victoria University, Melbourne, page 347.

43 Deloitte 2012, *FOFA Perspective: Advice delivery, Financial Services Risk and Regulatory Review*, Deloitte, Sydney, page 19.

44 Roy Morgan Research 2014, Data provided to the Financial System Inquiry, 5 November 2014, Australians aged 14+.

45 Australian Securities and Investments Commission (ASIC) 2013, *ASIC Stakeholder survey*, ASIC, Sydney, page 31. Survey conducted by Susan Bell Research, covering 1,468 stakeholders.

46 Australian Securities and Investments Commission 2014, Second round submission to the Financial System Inquiry, page 46.

that life insurance has higher arranging costs, such as managing the underwriting process, and that consumers are often not independently motivated to purchase life insurance. With the exception of group life insurance policies inside superannuation and an individual life insurance policy for a member of a default fund, life insurance products are exempt from the FOFA ban on commissions. This allows individual life policies to be sold with high upfront commissions, creating an incentive for advisers to make a sale, rather than provide strategic advice. For example, these policies can have 100–130 per cent of the first year's premium payable as upfront commissions, with an ongoing trail commission of around 10 per cent. A recent ASIC report on life insurance revealed significant problems with both compliance and the consequences for consumers.⁴⁷ More than a third of the personal advice reviewed failed to comply with the laws relating to appropriate advice and prioritising the needs of the consumer.

Upfront commissions can affect the quality of advice. ASIC found that 96 per cent of advice rated as a 'fail' was given by advisers paid under an upfront commission model. ASIC also found high upfront commissions encourage advisers to replace a consumer's policy rather than retain it.⁴⁸ In some cases, this may result in inferior policy terms. To date, industry approaches to address the issues in life insurance have not worked.⁴⁹

Stockbrokers

In recent years, ASIC has identified compliance issues in the stockbroking industry.⁵⁰ The Inquiry is aware of concerns with the prevalence of 'grid' commissions for advisers, where commission-based remuneration is received soon after advice is given, with the potential to create a conflict of interest between the adviser and the consumer. Australia and the United States are the only jurisdictions that use a grid commission structure. In most other major financial centres, stockbrokers are paid a salary and discretionary bonus. The Inquiry recognises it may be difficult for individual firms to change remuneration models without policy intervention because stockbrokers would move firms.

47 Australian Securities and Investments Commission (ASIC) 2014, *Report 413: Review of retail life insurance advice*, ASIC, Sydney, page 6.

48 Australian Securities and Investments Commission (ASIC) 2014, *Report 413: Review of retail life insurance advice*, ASIC, Sydney, page 5, 42.

49 However, note that the Financial Services Council and Association of Financial Advisers have now established a working group to address the issues raised by the ASIC report; Financial Services Council 2014, John Trowbridge to chair FSC-AFA life insurance working group, media release, 17 October.

50 Australian Securities and Investments Commission (ASIC) 2013, ASIC accepts enforceable undertaking from Macquarie Equities Ltd, media release, 29 January; ASIC 2011, ASIC accepts legally enforceable undertaking from UBS Wealth Management Australia, media release, 17 March.

Conclusion

To build confidence and trust in the financial system, financial firms need to be seen to act with greater integrity and accountability. The Inquiry believes changes are required not only to the regulatory regime and supervisory approach, but also to the culture and conduct of financial firms' management, which needs to focus on consumer interests and outcomes. A change in culture in line with community expectations should promote confidence and trust in the financial system and limit the need for more significant regulation.

Raising standards of conduct and levels of professionalism would require both a coordinated industry approach and focus of attention by individual firms. Industry associations could lead this initiative, with stakeholder input from ASIC and consumer organisations. Introducing or enhancing individual firm or industry codes of conduct is one way in which industry could set raised standards and hold themselves accountable.

An enhanced banning power should improve professional behaviour, management accountability and the culture of firms, by removing certain individuals from the industry and preventing them from managing a financial firm. This should also include individuals who are licence holders or authorised representatives, or managers of a credit licensee. It should prevent those operating under an Australian Financial Services Licence from moving to operate under a credit licence and vice versa.

For life insurance, the Inquiry recommends a level commission structure implemented through legislation requiring that an upfront commission is not greater than the ongoing commission. This would provide a balanced and cost effective approach to better align the interests of advisers and consumers. The remuneration model needs to be sustainable; otherwise there is a risk that providers may exit the market, making it more difficult for consumers to obtain life insurance advice. The findings of the Financial Services Council and the Association of Financial Advisers working group should also be considered during the development and implementation phases.

Alternative models of remuneration, such as delayed vesting of commissions and clawback arrangements, may simply delay the issue of churn and are complex. At this stage, the Inquiry does not recommend removing all commissions, as some consumers may not purchase life insurance if the advice involves an upfront fee. However, if level commission structures do not address the issues in life insurance, Government should revisit banning commissions.

The Inquiry has not determined the percentage amount of the level commissions that should apply in the life insurance sector. This should be left to the market and industry.

The Inquiry notes the FOFA ban on conflicted remuneration and associated measures are relatively new and should bring significant change to the industry and benefits for

Chapter 4: Consumer outcomes

consumers. However, some incentive-based remuneration models remain, including grandfathered arrangements and other specific exclusions. The Inquiry believes that these instances of conflicted remuneration should be monitored, and Government should intervene if further significant issues are observed.

Specific attention is required in the stockbroking sector in the immediate future. Unlike in the life insurance industry, a recent review of practices in stockbroking has not been undertaken. The Inquiry considers that ASIC should review current remuneration practices in stockbroking and advise Government on whether action is needed.

The Inquiry believes that better aligning the interests of financial firms with consumer interests, combined with stronger and better resourced regulators with access to higher penalties, should lead to better consumer outcomes.

Raise the competency of advisers

Recommendation 25

Raise the competency of financial advice providers and introduce an enhanced register of advisers.

Description

Government should continue the current process to raise the minimum competency standards for financial advisers.⁵¹

In the Inquiry's view, the minimum standards for those advising on Tier 1 products should include:

- A relevant tertiary degree.
- Competence in specialised areas, such as superannuation, where relevant.
- Ongoing professional development — including technical skills, relationship skills, compliance and ethical requirements — to complement the increased focus on standards of conduct and professionalism in *Recommendation 24: Align the interests of financial firms and consumers* in this chapter.

The standards should be reviewed regularly to ensure they take into account developments in the financial sector. In addition, compliance with the standards needs to be actively monitored. Transitional arrangements should be made to allow opportunity for advisers to upskill, and include recognition of professional experience.

In addition, ASIC should complete the establishment of an enhanced public register of all financial advisers, which includes those who are employees. The Inquiry considers that the register should include licence status, work history, education, qualifications and credentials, areas of advice, employer, business structure and years of experience.⁵²

51 Government is currently considering mechanisms to raise minimum education requirements.

52 Government has recently announced an enhanced register: Cormann, M (Minister for Finance and Acting Assistant Treasurer) 2014, An enhanced public register of financial advisers, media release, 24 October, Canberra.

Objectives

- Increase the likelihood of consumers receiving customer-focused quality advice.
- Promote confident and informed consumer use of financial advisory services.
- Facilitate consumer access to information about financial advisers' experience and qualifications to improve transparency and competition.

Discussion

Problems the recommendation seeks to address

Competency standards

The Interim Report observed that affordable, quality financial advice can bring significant benefits for consumers.⁵³ However, according to the Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS), “the major criticism of the current system is that licensees’ minimum training standards for advisers are too low, particularly given the complexity of many financial products”.⁵⁴ This affects confidence and trust in the sector and can prevent consumers from seeking financial advice.

A number of high-profile cases where consumers have suffered significant detriment through receiving poor advice, and a series of ASIC studies, have revealed issues with the quality of advice. For example, ASIC’s report on retirement advice found that only 3 per cent of Statements of Advice were labelled ‘good’, 39 per cent were ‘poor’ and the remaining 58 per cent ‘adequate’.⁵⁵ Although these cases and many of these studies occurred before the FOFA reforms to improve remuneration structures, this is not the only issue. Adviser competence has also been a factor in poor consumer outcomes. ASIC’s review of advice on retail structured products found insufficient evidence of a reasonable basis for the advice in approximately half of the files.⁵⁶

53 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 3-63.

54 Parliamentary Joint Committee on Corporations and Financial Services 2009, *Inquiry into financial products and services in Australia*, Canberra, page 87.

55 Australian Securities and Investments Commission (ASIC) 2012, *Report 279: Shadow shopping study of retirement advice*, ASIC, Sydney, page 8.

56 Australian Securities and Investments Commission (ASIC) 2013, *Report 377: Review of advice on retail structured products*, ASIC, Sydney, page 12.

Financial System Inquiry — Final report

Under the current framework, ASIC guidance sets out the minimum knowledge, skills and education for people who provide financial advice to comply with the *Corporations Act 2001* and licence conditions. The training standards vary depending on whether the adviser is dealing with Tier 1 or Tier 2 financial products.⁵⁷ As a minimum, current education standards are broadly equivalent to a Diploma under the Australian Qualifications Framework for Tier 1 products, and to a Certificate III for Tier 2 products.

Register of advisers

As the PJCCFS stated, “the licensing system does not currently provide a distinction between advisers on the basis of their qualifications, which is unhelpful for consumers when choosing a financial adviser”.⁵⁸ ASIC currently has a public record of financial advice licensees and is notified of authorised representatives. However, ASIC has little visibility of employee advisers, or access to the type of information that an enhanced register could hold, such as length of experience and employment history. ASIC argues that transparency about advisers through an enhanced register is an important piece missing from the regulatory framework.⁵⁹ Most stakeholders support introducing such an enhanced register.

Conclusion

The benefits of improving the quality of advice are significant. To achieve this, the Inquiry believes that minimum competency standards should be increased and the current Government process to review these standards should be prioritised.

In advance of the completion of the Government process, some adviser firms have recently announced they are increasing their own qualification requirements. However, low minimum competency standards have been a feature of the industry for a substantial length of time, and change is needed across the board. Many stakeholders are highly concerned about the low minimum education standards of financial advisers, with most supporting lifting education requirements to degree level.

57 Tier 2 products are generally simpler and better understood than Tier 1 products and are therefore subject to lighter training standards, including a lower educational level. Tier 2 includes basic banking products and general insurance products. Tier 1 covers the remainder, including superannuation, managed investment schemes, life insurance, securities and derivatives.

58 Parliamentary Joint Committee on Corporations and Financial Services 2009, *Inquiry into financial products and services in Australia*, Commonwealth of Australia, Canberra, page 90.

59 Australian Securities and Investments Commission 2014, Second round submission to the Financial System Inquiry, page 46.

Internationally, Singapore and the United Kingdom are seeking to raise minimum competency standards.⁶⁰ The Inquiry is of the view that Australia should set high standards in comparison with peer jurisdictions. Although the Inquiry does not recommend a national exam for advisers, this could be considered if issues in adviser competency persist.

For individual advisers and firms, the cost of undertaking further and ongoing education would be significant. However, this is a necessary transition to move towards higher standards of competence and would deliver long-term benefits for consumers. The cost would be mitigated by an appropriate transition period.

Raising the minimum competency standards may increase the cost of advice for consumers. However, various cost effective market developments are emerging, such as scaled or limited advice and using technology to deliver advice.⁶¹ The Inquiry encourages advisers to develop new models for delivering advice more cost effectively to sit alongside existing comprehensive face-to-face advice models.

The requirement for higher education standards may cause some existing advisers to exit the industry and may deter some from entering, potentially causing an 'advice gap' for some consumers. Transitional arrangements to give advisers appropriate time to upgrade their qualifications would help manage this risk. Raising standards would also increase confidence and trust in the industry, encouraging more individuals to choose financial advisory services as a career path, and increasing the supply of financial advisers.

The Inquiry has not made a recommendation in relation to mortgage brokers. However, it considers that ASIC should continue to monitor consumer outcomes in this area and the performance of the industry in relation to its obligations under the *National Consumer Credit Protection Act 2009*.

In relation to the register of advisers, the Inquiry supports the establishment of the enhanced register to facilitate consumer access to information about financial advisers' experience and qualifications and improve transparency and competition. Further

60 Monetary Authority of Singapore (MAS) 2013, MAS issues response to consultation on recommendations of Financial Advisory Industry Review, media release, 30 September, Singapore. In the United Kingdom, the Retail Distribution Review increased the minimum education standards for advisers to the equivalent of the first year of tertiary education: Financial Conduct Authority 2014, Data provided to the Financial System Inquiry, 24 October 2014.

61 Investment Trends data shows that 85 per cent of planners say they currently provide scaled advice to new clients. Around half (46 per cent) of these planners say they intend to provide even more single-issue advice (either scaled and/or transactional) over the next 12 months. While new advice and advice reviews over web chat is currently a niche, many advisers are interested in utilising this technology to engage with clients: Investment Trends 2014, *May 2014 Planner Business Model Report*, Investment Trends, Sydney. Based on a survey of 1,038 financial planners.

Financial System Inquiry — Final report

consideration could be given to adding other fields, such as determinations by the FOS.⁶² The register should be designed to take account of possible future developments in automated advice and record the entity responsible for providing such services.

⁶² Issues that would have to be addressed in achieving this include that determinations are currently made only against licence holders.

Improve guidance and disclosure in general insurance

Recommendation 26

Improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance.

Description

The general insurance industry should guide consumers as to the likely replacement value for home building and contents for the purpose of insurance. If significant progress is not made by industry within a short time frame, Government should consider introducing a regulatory requirement to provide this guidance at the point of renewal or on entering into a contract with a new insurer.

The general insurance industry should enhance existing tools and calculators for home insurance, including providing up-to-date information about building costs and building code changes.

The general insurance industry should complete its work on improving disclosure in insurance product disclosure documents, including consumer testing, and providing information at the appropriate point in the sales process.

Objectives

- Reduce the incidence of inadvertent underinsurance by assisting consumers to make an informed decision about the sum insured.
- Increase the ability of consumers to make informed decisions when taking out insurance.
- Enhance consumer understanding of insurance policies, especially key features, caps and limits, and exclusions.

Discussion

Problem the recommendation seeks to address

Many stakeholders are concerned about underinsurance flowing from natural disasters and high premiums, especially in disaster-prone areas. The cost of insurance can be high, especially for coverage in higher-risk areas such as flood plains and cyclone-prone areas, leading to non-insurance and underinsurance. The Inquiry believes this issue should be primarily handled by risk mitigation efforts rather than direct government intervention, which risks distorting price signals. (For more discussion on relevant issues, see *Box 12: General insurance and natural disasters*).

Financial System Inquiry — Final report

Studies after natural disasters reveal inadequate levels of insurance.⁶³ After the Canberra bushfires in 2003, ASIC found affected consumers were underinsured by 27 per cent on average. Research undertaken by Legal Aid NSW in relation to the Blue Mountains bushfires of 2013 found, “of the 68 survey participants who were insured and had suffered a total loss of their home at the Blue Mountains, a total of 82 per cent experienced some level of underinsurance for their home building policy and/or home contents policy”.⁶⁴

Replacement value

The current regulatory settings allow insurers to provide guidance on the replacement value of home building or contents without needing to comply with the personal advice rules.⁶⁵ At present, this is not working and insurers are not typically providing guidance on replacement value. The Inquiry believes that commercial disincentives mean insurers are reluctant to provide this type of guidance. Although many insurers provide online calculators to estimate replacement value, insurers typically refrain from giving guidance on the replacement value either over the phone or on a renewal notice. A recent ASIC report identified that most insurers operate on a ‘no advice’ or factual information model.⁶⁶

The draft Productivity Commission (PC) report on natural disaster funding arrangements commented on a number of important issues consumers face during natural disasters, including a lack of consumer understanding about risk and insurance leading to non-insurance and underinsurance.⁶⁷ Underinsurance often occurs because most standard home building and contents insurance policies require the consumer to decide on the amount of insurance. One of the causes of underinsurance includes consumers setting their replacement value amounts too low, due to a lack of knowledge and the specialist skills required to more accurately estimate the cost of rebuilding a home and replacing home contents.⁶⁸

The ASIC report found that “consumers frequently sought assistance from insurers about how best to decide a sum insured amount”. However, in many instances, sales staff advised they were not able to assist. Insurers have access to information that allows them to assess replacement value better than consumers. However, insurers typically do not give phone-based guidance or refer consumers to existing online tools

63 Australian Securities and Investments Commission (ASIC) 2005, *Report 54: Getting home insurance right*, ASIC, Sydney; ASIC 2007, *Report 89: Making home insurance better*, ASIC, Sydney.

64 Legal Aid NSW 2014, Second round submission to the Financial System Inquiry, page 5.
65 *Corporations Act 2001*, s766B(6).

66 Australian Securities and Investments Commission (ASIC) 2014, *Report 415: A review of the sale of home insurance*, ASIC, Sydney, pages 9, 10, 47.

67 Productivity Commission 2014, *Draft Report: Natural disaster funding arrangements*, Volume 1, Commonwealth of Australia, Canberra, page 31.

68 Australian Securities and Investments Commission (ASIC) 2005, *Report 54: Getting home insurance right*, ASIC, Sydney, page 5.

and calculators, which would help with these replacement estimates.⁶⁹ Renewal notices also typically do not include this information. The Inquiry believes that it is important for insurers to provide guidance on replacement value to consumers to lessen the risk of underinsurance.

Tools and calculators

Tools and calculators can be updated to help consumers estimate replacement costs more accurately. The Inquiry acknowledges that the insurance market has developed some tools to address 'estimation risk'; for instance, providing 'uplift' factors to sums insured, indexation or inflation adjustments to sums insured, and technological tools designed to assist consumers. However, the Inquiry sees further scope to address this issue, including the industry improving tools and calculators by referencing up-to-date building costs and changes in building codes that may affect rebuild cost. The draft PC report discussed how information imbalances may increase underinsurance due to consumers being unable to access relevant information, such as changes to building codes that may increase the cost of building a home.⁷⁰

Disclosure

Although general insurance has a specific product disclosure regime, the industry lacks standard practice in describing a policy's key features and exclusions. The PC also commented on the difficulties consumers face in understanding the information they receive about their insurance policy.⁷¹

Survey results highlight that even when consumers take the time to read insurance documentation including the product disclosure statement, many misunderstand it, scan it briefly due to over-reliance on sales staff or fail to understand it due to its complexity.⁷² For example, as a consequence of recent natural disasters, it became clear many consumers did not understand whether they were covered for flood. A survey by the Caxton Legal Centre after the Queensland floods of 2011 found that of participating consumers:

- 51 per cent read the policy but misunderstood important exclusions or limitations.
- 12 per cent received the policy but never read it.
- 4 per cent tried to read the policy but gave up as they could not understand it.

69 Australian Securities and Investments Commission (ASIC) 2014, *Report 415: A review of the sale of home insurance*, ASIC, Sydney, page 10.

70 Productivity Commission 2014, *Draft Report: Natural disaster funding arrangements*, Volume 2, Commonwealth of Australia, Canberra, page 385.

71 Productivity Commission 2014, *Draft Report: Natural disaster funding arrangements*, Volume 2, Commonwealth of Australia, Canberra, page 385.

72 Caxton Legal Centre Inc 2011, Submission to the Standing Committee on Social Policy and Legal Affairs: Inquiry into the operation of the insurance industry during disaster events, page 16.

Conclusion

The Inquiry believes that underinsurance would reduce if, as standard practice, insurers gave consumers relevant information, guidance and advice on home building and contents insurance. Some stakeholders argue that total replacement policies would be the best solution to the issue of underinsurance. However, this may increase risk for insurers, which may exacerbate affordability issues. The Inquiry considered whether introducing standardised or default insurance products would reduce the risk of consumers failing to understand policies' key features and exclusions. On balance, the Inquiry considers the consequent reduction in competition and potential disincentive for innovation does not warrant this kind of response.

The Inquiry encourages insurers to provide consumers with enhanced guidance about likely replacement values, and to develop further and make consumers aware of tools that can help them to purchase adequate insurance cover. Industry should standardise the way replacement costs are estimated. To the extent this is limited by the existing regulatory regime, industry should work with Government to resolve. Such estimates should be given at the time of purchase, and changes to replacement costs should be communicated to consumers at each renewal.

Insurers providing consumers with enhanced guidance on replacement values would lessen the risk of underinsurance and increase confidence and trust in the sector. This may also reduce the need for governments to provide assistance after natural disasters. If, within the short term, industry has not made significant progress in providing this guidance to consumers, the Inquiry considers that Government should require industry to provide it.

The Inquiry believes the general insurance industry should complete its recent work on reducing complexity and facilitating consumer understanding of key features and exclusions, including relevant consumer testing. This work can be a useful supplement to the key facts sheet for home building insurance, which was introduced in November 2014.⁷³ Insurers could also incorporate elements of the key facts sheet when giving information, guidance and advice over the phone and online.

The Inquiry believes that the recommendations build on existing industry work and practices, and should have lower implementation costs than compliance with a prescriptive regulatory regime.

⁷³ Insurance Contracts Regulations 1985, Part 4, Division 4.

Box 12: General insurance and natural disasters

Many stakeholders raised concerns in relation to general insurance. The Interim Report highlighted two issues on general insurance and natural disasters:

1. The costs of insurance, especially for coverage in higher-risk areas, such as flood plains and cyclone-prone areas. It observed that increased use of risk-based pricing is likely to increase premiums in these areas.
2. The incidence of underinsurance following a natural disaster, especially inadvertent underinsurance, where homeowners underestimate the cost of rebuilding.

Cost of insurance

High premiums can lead to calls for government intervention; for example, in relation to the cost of home and strata title insurance in North Queensland. The Australian Government Actuary, which has completed two reports on the issue, attributed recent price increases to historic underpricing of coverage, higher reinsurance costs and the cost of natural disasters. It also found that insurers were providing appropriate risk-based products and pricing.⁷⁴

The Inquiry recognises a few areas where the absence of private sector providers creates a need for governments to provide insurance; for example, for terrorism insurance or cover for catastrophic personal injuries. However, in most cases, the Inquiry considers the main role of government is to support the market in working as effectively as possible rather than subsidising prices. The costs of natural disaster insurance can be reduced through improved data, further mitigation efforts – such as building flood levies, and in the case of states and territories, by reducing the tax burden on insurance contracts (see *Appendix 2: Tax summary*). The Inquiry notes Government has recently decided to provide a comparison website for home insurance in North Queensland and has clarified that unauthorised foreign insurers may provide some competition and offer lower prices in targeted areas prone to natural disaster.⁷⁵

74 Australian Government Actuary (AGA) 2014, *Second report on investigation into strata title insurance price rises in North Queensland*, Commonwealth of Australia, Canberra, pages 19–20; AGA 2012, *Report on investigation into strata title insurance price rises in North Queensland*, Commonwealth of Australia, Canberra, pages 7, 16–17.

75 Cormann, M (Minister for Finance and Acting Assistant Treasurer) 2014, Initiatives to help address insurance affordability in North Queensland, media release, 23 October, Canberra; Senate Economics Legislation Committee 2014, *Hansard transcript*, 31 October, Commonwealth of Australia, Canberra, pages 13–25.

Box 12: General insurance and natural disasters (cont.)

Insurance coverage and underinsurance

Price competition can also help to address underinsurance. For mass-marketed insurance products, governments can play a role in encouraging comparison websites. In *Chapter 3: Innovation*, the Inquiry recommends the PC review how data can be used more effectively to enhance consumer outcomes, better inform decision making, and facilitate greater efficiency and innovation in the financial system.

Statutory insurance is insurance that is mandatory; for example, compulsory third-party motor vehicle insurance, workers' compensation insurance and professional indemnity insurance. While there are strong justifications for making some insurance cover mandatory (especially liability insurance) where the detriment is to third parties, governments imposing this requirement should take steps to encourage an adequate market (where they do not provide the cover themselves). Where governments provide insurance in competition with the private sector, this should be done on the basis of competitive neutrality.

Chapter 5: Regulatory system

Australia needs strong, independent and accountable regulators to help maintain trust and confidence in the financial system. This is critically important for attracting investment and supporting growth. The quality of oversight and supervision is vital in maintaining financial stability and achieving positive consumer outcomes.

Appropriate firm culture is critical, but needs to be supported by proactive regulators with the right skills, culture, powers and funding.

Australia's regulatory system, as described in the Interim Report, is a legacy of the Wallis Inquiry's functional approach to regulation.¹ This means regulators generally focus on particular outcomes across the system, rather than particular sectors.² The Australian Prudential Regulation Authority (APRA) specialises in prudential regulation of banking, insurance and superannuation, while the Australian Securities and Investments Commission (ASIC) has a broader conduct and market integrity mandate.³

Since the Wallis Inquiry, Australia's regulatory system has undergone significant change. The overall approach to prudential regulation changed significantly in the wake of the collapse of HIH Insurance Limited (HIH) in 2001. There has been a stronger focus on developing tools for crisis management and resolution. APRA also acquired a more active role in the superannuation sector.⁴ In addition, ASIC's mandate expanded significantly, assuming responsibility for regulating credit as well as financial market supervision.

The global financial crisis (GFC) prompted policy makers and regulators around the world to reconsider their approach to maintaining financial stability. Some countries at the epicentre of the crisis have since expanded their prudential perimeters and adopted more formal and centralised institutional arrangements. This includes establishing single entities with responsibility for macro-prudential regulation.

Australia has long adopted what could be called a 'macro-prudential' approach to supervision under the rubric of financial stability. Yet, Australia's institutional structure is relatively informal and decentralised. The Reserve Bank of Australia (RBA) and APRA each have responsibility for financial stability. However, most macro-prudential tools can only be deployed by APRA. This places a strong premium on cooperation between the two agencies.

1 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 3–90.

2 The exception is the Payments System Board, which focuses on the payments industry.

3 This is described as the 'twin peaks' model.

4 This includes trustee licensing, the capacity to make prudential standards and authorisation of MySuper products.

Financial System Inquiry — Final report

Against the background of developments overseas, the Inquiry has considered whether Australia should change its institutional arrangements for making and implementing financial stability policy.

However, the Inquiry does not see a strong case for change in this area. Although Australia's approach has advantages and disadvantages, alternative institutional approaches are yet to be tested — as indeed is the effectiveness of many macro-prudential tools. For this reason, the Inquiry recommends no fundamental change to the current institutional arrangements for financial stability policy and no change to the prudential perimeter at this time.⁵ However, it believes that the RBA should continue to monitor risks in the non-prudentially regulated sector, and the Council of Financial Regulators (CFR) should periodically consider whether change is required.⁶

The Inquiry does not see a need to expand the permanent membership of the CFR to include the Australian Competition and Consumer Commission (ACCC), the Australian Transaction Reports and Analysis Centre (AUSTRAC) or the Australian Taxation Office (ATO), as these agencies can already attend meetings as necessary. However, there would be benefit in increasing the transparency of the CFR's deliberations, including its assessment of financial stability risks and how these are being addressed.

The Inquiry also considered whether superannuation outside self-managed superannuation funds (SMSFs) should still be subject to prudential regulation by APRA and whether to narrow ASIC's responsibilities.

The Interim Report identified that defined contribution superannuation is different to banking and insurance and therefore needs to be regulated differently. Unlike deposit accounts, defined contribution superannuation balances are intended to be exposed to market risk, and do not guarantee a particular return. However, the Inquiry believes the compulsory nature of superannuation justifies ongoing prudential regulation by APRA, including the availability of compensation in the event of fraud or theft.

Some submissions suggest that SMSFs might be prudentially regulated by APRA.⁷ The Inquiry does not support this. The defining characteristic of the SMSF sector is that trustee members are directly responsible for each fund and must take responsibility for their own decisions.

5 The section on graduated payments regulation in *Chapter 3: Innovation* recommends making some changes to the current authorisation regime that applies to purchased payment facilities. It recommends that the current arrangements should be replaced with a two-tiered authorisation regime.

6 The Financial Stability Board produces an annual survey of the global shadow banking sector, including that in Australia.

7 Financial Services Council 2014, Second round submission to the Financial System Inquiry, Chapter 3, page 89; Actuaries Institute 2014, Second round submission to the Financial System Inquiry, page 8.

The Inquiry agrees there is scope to separate ASIC's registry business from the rest of its functions, but is not persuaded that there is a strong case for removing other functions. Neither has it recommended any additions to ASIC's responsibilities.⁸ The Inquiry accepts the view that there are synergies between functions – such as market supervision, insolvency and consumer protection – that would be lost if these functions were moved to other agencies. The Inquiry has not recommended giving the ACCC sole responsibility for consumer protection because these powers are an important part of ASIC's enforcement toolkit. The Inquiry sees value in an integrated consumer regulator for financial services.⁹

Although there is no need for major change to the responsibilities of the regulators, the Inquiry has identified some weaknesses in how financial regulation is implemented and believes there is scope to improve regulatory processes. It notes: Government lacks a process for holding regulators accountable for their overall performance; some significant weaknesses exist in regulator funding arrangements and enforcement tools, particularly for ASIC; and competition and efficiency in designing and applying regulation may not be adequately considered.

Recommended actions

While the Inquiry does not recommend major changes to the overall regulatory system, it believes action should be taken in the following five areas to improve the current arrangements and ensure regulatory settings remain fit for purpose in the years ahead:

- **Improve the regulator accountability framework:** Australia needs a better mechanism to allow Government to assess the performance of financial regulators. The Inquiry recommends establishing a new Financial Regulator Assessment Board (Assessment Board) to undertake annual ex post reviews of overall regulator performance against their mandates. It also recommends that Government should provide more clarity around its expectations of regulators, including its appetite for risk in the financial system, while regulators should develop better performance indicators. These new arrangements should ensure, among other things, regulators give stronger and more transparent consideration to competition and compliance cost issues.
- **Improve the effectiveness of our regulators:** Australia's regulatory system will continue to be challenged by the pace of technological change. Especially in payments and financial markets, new business models are challenging existing

8 The Interim Report asked whether ASIC should regulate technology providers and superannuation administrators of scale, and whether securities dealers who are not direct market participants should be regulated as market participants: Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, pages 3-106 to 3-108.

9 ASIC currently has exclusive responsibility for consumer protection in relation to financial services and credit, while the ACCC has these powers in relation to the rest of the economy.

regulatory frameworks. The emergence of new technology is placing demands on regulators to be more flexible, and raising issues relating to identity, privacy and cyber security. Australia's regulators need the funding and skills to meet these challenges into the future, including encouraging innovation through appropriately graduated approaches.

The Inquiry recommends that ASIC and APRA should both be strengthened through increased budget stability built on periodic funding reviews, and greater operational flexibility. ASIC, APRA and the payment systems function of the RBA should also commit to six-yearly capability reviews. These exercises should ensure they have the required skills and culture to maintain effectiveness in an environment of rapid change, as will the recommendation in *Chapter 3: Innovation* that Government create a new public-private collaboration mechanism to facilitate regulatory change in response to innovation.

- **Strengthen ASIC:** Instances of misconduct and consumer loss in the financial system have prompted questions about the effectiveness of consumer protection, as well as the adequacy of ASIC's resources and the design of the regulatory framework in which it operates. The public expectation is that ASIC will act as a pro-active watchdog in supervising all financial services providers. However, in practice, ASIC has a very wide remit but limited powers and resources.

The Senate Economics References Committee's report on ASIC's performance was released just before the publication of the Interim Report. The Interim Report indicated that the Inquiry would consider the Senate Committee's recommendations in the lead-up to its Final Report.¹⁰

Several of the recommendations in this Final Report are consistent with those of the Senate Committee. The Inquiry has recommended some fundamental changes to the regulatory framework governing the financial services industry (see *Chapter 4: Consumer outcomes*). These measures are part of a broad shift in Australia's approach to consumer protection in the financial sector – away from primarily relying on disclosure and financial literacy.

The Inquiry has also recommended changes in how ASIC approaches its consumer protection role. In particular, the Inquiry considers that ASIC should devote more attention to industry supervision, including more proactively identifying and weeding-out misconduct. It has also recommended several measures to strengthen ASIC, including better funding, enhanced regulatory tools (including the proposed product intervention powers discussed in *Chapter 4: Consumer outcomes*), stronger licensing powers to address misconduct, and substantially higher criminal and civil penalties.

¹⁰ Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 3-89.

In light of the significance of these changes, the Inquiry recommends that ASIC should be the first regulator to undergo a capability review, along with the funding review that would take place under the recommendation for increased budget stability. This would help to ensure ASIC has the appropriate skills and culture to adopt a flexible risk-based approach to its future role. Its overall performance would also be subject to annual review by the proposed new Assessment Board.

- **Rebalance the regulatory focus towards competition:** Not surprisingly, regulators have increased their focus on resilience in the wake of the GFC. However, the Inquiry believes there is complacency about competition, and that the current framework does not systematically identify and address competition trade-offs in regulatory settings.

Although the ACCC is responsible for competition policy in the financial sector, this is part of its broader economy-wide responsibilities. Furthermore, the ACCC is not responsible for reviewing how decisions by other regulators affect competition. It is not always clear how APRA and ASIC balance their core regulatory objectives against the need to maintain competition. Policy makers and regulators need to take increased account of competition when making regulatory decisions, while ASIC should be given an explicit competition mandate. Periodic external reviews of the state of competition should be conducted, including assessing whether Australia can reduce barriers to market entry for new domestic and international competitors.

- **Improve the process of implementing new financial regulations:** Since the GFC, Australia's financial system has been influenced by new global standards and the increasing scope and complexity of cross-border financial regulation. Substantial regulatory change has resulted from international developments and decisions made in major offshore financial centres, concurrent with a large number of domestically driven changes, especially in financial advice and superannuation.

Although there is no evidence to suggest Australia's compliance burden is substantially larger than in jurisdictions overseas, work commissioned by the Inquiry suggests that improved regulatory processes could reduce industry costs and lead to better outcomes. Specifically, the Inquiry recommends that Government and regulators adhere to minimum implementation lead times and monitor impacts more thoroughly post-implementation.

Principles

In making recommendations in this chapter, the Inquiry has been guided by the following principles:¹¹

- The system must have highly skilled, effective regulators that are both independent and accountable for discharging their mandates.
- Competition is the cornerstone of a well-functioning financial system and is generally preferred to Government intervention as the mechanism for efficient, resilient and fair outcomes. Policy makers and regulators should minimise barriers to domestic and international competition and seek to encourage competition.
- Regulators and regulation must be forward looking, with the flexibility and capability to cope with a changing environment. Effective regulators need to be able to offer competitive salaries.
- Regulation and regulators should be cost effective, and the benefits of regulation should outweigh the cost. Costs should be allocated to those who create the need for regulation.
- The culture of firms is important and will affect the need for regulation.

Conclusion

Adopting the recommendations in this chapter will make Australia's regulators more effective, more adaptable and more accountable, with greater independence in some areas, such as funding. It will also increase the focus on competition and improve how regulations are made and reviewed.

¹¹ Drawing on the principles set out in Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, pages 1–7.

Regulator accountability

Recommendation 27

Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates.

Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.

Description

Government should create a new Assessment Board to provide it with ex post, annual reports on the performance of APRA, ASIC and the payment systems regulation function of the RBA. They would be assessed against their statutory mandates as well as against the priorities identified in Statements of Intent (SOIs).¹²

The reports would consider how the regulators have balanced the different components of their mandates as well as how they are allocating resources and responding to strategic challenges. Reports should include the views of regulators and be made public once Government has had the opportunity to consider a response. The Assessment Board need not be established as a separate agency and could be supported by a separate secretariat housed in Treasury. This would separate the provision of support to the Assessment Board from Treasury's ongoing policy role as a CFR agency.

It is not intended that the Assessment Board should direct the regulators – it would report to Government. It would also be precluded from examining individual complaints against regulators or the merits of particular regulatory or enforcement decisions. However, it would be asked to assess how regulators have used the powers and discretions available to them. In the case of ASIC, a significant issue would be its use of the temporary product intervention power recommended in *Chapter 4: Consumer outcomes*.

The Assessment Board would replace the current Financial Sector Advisory Council (FSAC). It would consist of between five and seven part-time members with industry and regulatory expertise. It would not include current employees of regulated entities. However, members would be expected to consult extensively with industry and consumer stakeholders. Diversity of membership should act as a safeguard against the

¹² The Assessment Board would not review the mandates of regulators or the frameworks they administer.

Financial System Inquiry — Final report

Assessment Board being unduly influenced by the views of one particular group or industry sector.¹³

Government should also set out more clearly how regulators should interpret their mandates in Statements of Expectation (SOEs). SOEs should also set out:

- A statement of the strategic direction Government expects regulators to take, including in response to changing circumstances.
- A broad outline of Government's tolerance for financial sector risk.

Regulators should increase their use of outcomes-focused performance indicators. These could be included in SOIs, as per the practice of New Zealand regulators, or in annual reports.^{14,15} Performance indicators should cover core regulatory objectives as well as competition and compliance cost objectives.

Regulators should more clearly explain in their annual reports how they have balanced the different parts of their mandates, particularly the effect of their decisions on competition and compliance costs. This information would be an important input into the Assessment Board's annual reviews, along with other relevant reports produced by regulators.¹⁶

These recommendations are intended to be consistent with, and not duplicate, Government's Regulator Performance Framework (see *Implementation considerations*).

Objectives

- Create a formal mechanism for Government to receive annual independent advice on regulator performance.
- Strengthen the accountability framework governing Australia's financial sector regulators.

13 A code of conduct for members could also be used to address this issue.

14 See, for example, Reserve Bank of New Zealand (RBNZ), 2014, *Statement of Intent*, RBNZ, Wellington, page 11.

15 Increased use of performance indicators in annual reports is likely to be consistent with the new performance reporting requirements that will apply under the *Public Governance, Performance and Accountability Act 2013*, these requirements would be broader than the Regulator Performance Framework that Government has already announced.

16 For example, ASIC publishes a Strategic Outlook as well as periodic reports on relief decisions and enforcement outcomes. APRA and ASIC both publish periodic stakeholder surveys.

Discussion

Problems the recommendation seeks to address

Australia's financial regulators operate within complex accountability frameworks. A range of bodies carry out narrow rather than overall performance assessments. For example, the Australian National Audit Office (ANAO) conducts performance audits in relation to particular programs or activities, and the Office of Best Practice Regulation reviews Regulation Impact Statements (RISs) on proposed regulatory changes, while the courts and other quasi-judicial bodies review specific decisions.

The main problem with the current arrangements is Government lacks a regular mechanism to assess the overall performance of its financial regulators. Parliament has mechanisms to do this, including review of annual reports. However, parliamentary scrutiny tends to be episodic and focus on particular issues or decisions. The complexity of regulator mandates presents a challenge to effective monitoring, especially as Parliament is not supported in this role through regular independent assessments of annual reports.

The core mandates of the regulators are generally clear. APRA is responsible for maintaining financial stability; protecting the claims of authorised deposit-taking institution depositors and insurance policy-holders; and promoting prudent management of non-SMSF superannuation funds. ASIC is responsible for consumer protection and market integrity. The RBA and Payments System Board (PSB) are responsible for financial stability and controlling risk in the financial system. Each regulator is required to balance these core responsibilities against other objectives, including promoting competition and efficiency, maximising business certainty and minimising compliance costs. However, there is some inconsistency in how these other objectives are framed in relation to APRA and ASIC, including whether or not they apply at all.¹⁷

Regulators currently receive little guidance about how they should balance the different objectives in their respective mandates. At present, SOEs typically list each regulator's objectives, without guidance from Government on its tolerance for risk, or how it expects the regulators to balance the different components of their mandates,

¹⁷ The *Australian Prudential Regulation Authority Act 1998* requires APRA to consider efficiency, competition, contestability and competitive neutrality alongside financial safety and stability. The objects clauses in the *Banking Act 1959* and *Superannuation (Industry) Supervision Act 1993* do not mention competition or efficiency. The objects clauses in the *Insurance Act 1973* and *Life Insurance Act 1995* identify competition and innovation as objectives (subject to industry viability). There is no reference to reducing compliance costs. The *Australian Securities and Investments Commission Act 2001* (ASIC Act) requires ASIC to promote commercial certainty and economic development and efficiency while reducing business costs. However, there is no explicit reference to competition in the ASIC Act (or the objects clause for Chapter 7 of the *Corporations Act 2001*).

Financial System Inquiry — Final report

especially where there may be a trade-off between objectives.¹⁸ Similarly, annual reports by regulators provide scant information on how they have balanced their different objectives. As the Inquiry noted in its Interim Report, regulators' annual reports lack performance indicators.

The FSAC, created as a recommendation of the Wallis Inquiry, is currently the main formal mechanism for industry stakeholders to provide advice to Government. Although FSAC has attracted high-calibre members, and has performed a useful role in relation to some issues, it has been hampered by the lack of a clear mandate and regular work program. This means that its influence has varied over time.

Rationale

A more effective review mechanism that provides Government with regular formal advice on the overall performance of regulators will improve regulator accountability.

Options considered

The Interim Report proposed improving SOEs, SOIs and annual reports. It identified two options to strengthen external oversight of financial regulators: an Inspector-General of Regulation and a 'unified oversight authority'. Second round submissions also suggest the CFR could play a larger role in monitoring the performance of regulators.

1. **Recommended:** Create a new Assessment Board to advise Government annually on how regulators have implemented their mandates, based on regulator self-assessments, periodic capability reviews and industry consultation.
2. **Recommended:** Provide clearer guidance to regulators in SOEs, and increase the use of performance indicators to strengthen regulator reporting.
3. Appoint an Inspector-General of Regulation or unified oversight authority for financial system regulators.
4. Formalise the CFR and task it to hold regulators accountable for performance against their mandates.
5. Place APRA and ASIC under the control of boards comprising executive and non-executive directors.

Options costs and benefits

Submissions generally support improved accountability mechanisms for regulators.

¹⁸ For example, lowering barriers to entry may benefit consumers by strengthening competition but also increase risks for end-users. Likewise, higher barriers to entry can have the opposite effect.

Annual reviews of performance by a new Assessment Board

Establishing a new Assessment Board has the potential to provide more focused oversight of regulator performance. However, the success of the Assessment Board will depend on how it approaches its task. Some of the risks associated with this recommendation are that the Board simply becomes another accountability process that adds to costs without adding value, or that it attempts to intervene directly in the work of the regulators. Another risk is that it undermines Treasury's relationship with the other CFR agencies.

The Inquiry has sought to address these risks by making it clear that the Assessment Board should have a diverse membership to avoid being unduly influenced by a particular group; limiting the Board's mandate to ex post overall assessments of regulator performance; ensuring the Board bases its assessments on existing outputs where possible; and suggesting that the Board be supported by a separate secretariat within Treasury. A diverse membership would also help ensure a balance of views and deal with potential conflicts involving individual members.

Improve SOEs and increase use of performance indicators

There appears to be widespread support for improving SOEs and SOIs, and increasing the use of performance indicators as a means of enhancing regulator accountability. The main issues are the extent to which Government is willing to be more explicit about trade-offs in regulatory policy (especially its risk appetite) and the capacity of regulators to devise performance indicators that adequately capture the complexity of their work. While Government may be reluctant to set out views, and developing performance indicators is a difficult exercise, the Inquiry believes that increased efforts in these areas would enhance regulator accountability.

Inspector-General of Regulation or unified oversight authority

The Inquiry does not support the Inspector-General model because it would involve creating a new agency. The Assessment Board would replace the existing FSAC. The Inspector-General model would place considerable reliance on a single person, while the Assessment Board can include members with expertise across the regulators. Finally, the Inquiry considers an Assessment Board is more suited to undertaking an overall review of regulator performance, while the Inspector-General model is better suited to undertaking more detailed assessments of administrative processes of the type currently performed by the ANAO and the Inspector-General of Taxation (in relation to the ATO).

Formalise the CFR as oversight body

The Inquiry does not support creating a separate body with an overarching oversight or review role because it would fundamentally change the current regulatory system. If the CFR was to perform this role, as some submissions suggest, it would be transformed from a mechanism to facilitate cooperation between regulators into a

separate agency in its own right. This would result in overlapping responsibilities and weaken accountability.

Place APRA and ASIC under the control of boards

This option was raised by the Senate Economics References Committee in its report on the performance of ASIC.¹⁹ It has also been identified as an option for the ACCC in the Draft Report of the Competition Policy Review.²⁰

The non-executive board model was used by APRA when it was established. However, the Royal Commission into the collapse of HIH concluded that this arrangement had blurred accountability for regulatory outcomes between the board and the chief executive officer, and that APRA would be better headed by a small full-time executive, with the capacity to establish an advisory board if necessary.²¹

Conclusion

The Inquiry believes that creating a new Assessment Board to review regulator performance is the best way to address the gap it has identified in the current accountability framework. This option would facilitate improved scrutiny of regulator performance without creating new agencies or compromising existing accountability relationships. This recommendation is not intended to reduce the independence of regulators in executing their statutory mandates.

Implementation considerations

Interaction with Government's new Regulator Performance Framework

Under the new Regulator Performance Framework, regulators will have to undertake an annual externally-validated self-assessment of their performance to minimise the burden on their regulated populations. Selected regulators will also have their performance assessed externally by a review panel every three years, with the option of an annual review for major regulators.

Annual reviews by the Assessment Board would be broader than the process envisaged under the Regulator Performance Framework. Although they would encompass compliance cost issues, this would be only one element of overall performance. To avoid duplication, the Assessment Board could act as the validation body for each regulator's annual self-assessment, and this assessment could be used in the Board's deliberations. This would remove the need for two separate processes.

19 Senate Economics References Committee 2014, *Performance of the Australian Securities and Investments Commission*, Commonwealth of Australia, Canberra, Recommendation 55, page 433.

20 Commonwealth of Australia 2014, *Competition Policy Review, Draft Report*, Canberra, Draft Recommendation 47, page 63.

21 HIH Royal Commission 2003, *The Failure of HIH Insurance Volume 1 of 3, Part Three*, Commonwealth of Australia, Canberra, Recommendations 18 and 19.

Other issues

Government should consider whether agencies outside the Treasury portfolio that have a significant effect on the financial system, such as AUSTRAC, should be assessed by the Assessment Board.

The remit of the Assessment Board should be narrow and specifically exclude:

- Assessments of the merits of relief for particular transactions, enforcement actions and individual complaints against the regulators.
- Matters of financial system regulation policy, such as whether the mandates of regulators are appropriate.

Execution of mandate

Recommendation 28

Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews.

Description

Government should continue to determine the level of funding for APRA and ASIC. However, APRA and ASIC should be given greater year-to-year certainty in their funding profiles as well as more flexibility in how they spend their budgets, including their remuneration policies. Adopting a more rigorous funding model would provide the regulators with more certainty, while enhancing transparency and efficiency. As part of this model:

- Regulator funding should be set by Government based on the recommendation of three-yearly funding reviews. These reviews should include consultation with industry and consumer stakeholders.
- Once determined, funding would remain stable between reviews, subject to appropriate indexation and efficiency arrangements.²² Changes would only be made if there were a significant change in the scope of a regulator's mandate, or an emergency event such as a financial crisis.

Regulators should be funded at a level that enables them to offer remuneration that is competitive with the private sector. Effective regulation depends on effective human capital, and more effective regulators are likely to require higher salaries. Regulators currently target average remuneration at the 25th percentile of the market rate for like work in the financial sector; however, the Inquiry is concerned they currently find it difficult to meet this target.

The Inquiry is also concerned this target may be too low, preventing regulators from offering market-median or higher remuneration to attract more specialised and senior staff with strong market experience without median pay for other staff falling well below the 25th percentile.

²² The efficiency measure may be a fixed efficiency dividend, or some other tailored efficiency measure. It should be applied upfront as part of the funding review process to ensure regulator funding remains stable over the estimates period.

ASIC staff should be removed from coverage by the *Public Service Act 1999* (Public Service Act) to bring it into line with APRA and the RBA. APRA and ASIC should be able to opt out of public sector-wide employment, staffing, and other whole-of-Government policies and procedures that unnecessarily constrain their flexibility to deliver their regulatory mandate.

APRA, ASIC and the payments system regulation function of the RBA should each conduct six-yearly forward-looking capability reviews to ensure they remain fit for purpose and have the capabilities to address future regulatory challenges.

Objective

- Ensure Australia's regulators are fit for purpose and have the funding, staff and regulatory tools to deliver effectively on their mandates.

Discussion

Problems the recommendation seeks to address

Funding for APRA and ASIC

The Interim Report set out the following principles for funding the regulators:²³

- Funding should have a high degree of stability and certainty.
- Total funding should be proportionate to the task.
- Regulatory costs should be borne by those contributing to the need for regulation.
- Funding should promote the independence and accountability of the regulators.

The funding arrangements currently applying to APRA and ASIC do not reflect these principles. Regulators lack stable funding. They are subject to unpredictable budget reductions and unexpected efficiency dividends that limit their capacity to plan how they will dedicate resources beyond the short term. ASIC funding was reduced in the 2014–15 Budget. At the same time, APRA and ASIC were subject to additional whole-of-Government efficiency dividends in the 2014–15 Budget, the 2013–14 Economic Statement and the 2011–12 Budget. Submissions support the view that financial regulator funding should have a high degree of stability and certainty.

The Inquiry has not carried out its own assessment of the adequacy of regulator funding. However, submissions from both industry and consumer stakeholders argue that ASIC is not adequately funded to carry out its current consumer protection mandate in relation to the financial services industry, let alone the more proactive role

²³ Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, pages 3-110 to 3-111.

Financial System Inquiry — Final report

the Inquiry recommends ASIC should adopt in the future.²⁴ ASIC has also relied heavily on specific-purpose funding. Periodic funding reviews would allow Government to determine whether the regulators have sufficient funding to execute their mandates. The Inquiry recognises that funding reviews are not simple tasks. However, it believes there should be more consideration of the resources that regulators require to deliver effectively on their mandates.

APRA's industry funding arrangements mean its costs are generally borne by prudentially regulated entities. This is not currently the case with ASIC. The next recommendation in this chapter – that industry funding should also be adopted for ASIC – will address this issue.

Current funding arrangements do not promote regulator independence and accountability. These would improve if funding levels were based on periodic funding reviews rather than annual Government decisions, and if regulators had more discretion in determining how funding is used. Funding reviews would ensure sufficient resources to support other recommendations in this report, such as ensuring regulators can offer remuneration that allows them to compete effectively with the private sector for talent.

Operational flexibility

APRA and ASIC are both subject to policies that limit their capacity to attract and retain staff from the private sector. In particular, public sector-wide industrial relations policies are a poor fit for APRA and ASIC, whose employees are typically recruited from the private sector.²⁵ Second round submissions agree with the proposition that APRA and ASIC should have more flexibility over staffing and be able to offer competitive remuneration. Indeed, industry participants recognise the value of competent and experienced regulators.²⁶

Unlike APRA and the RBA, ASIC is subject to the Public Service Act. Yet there is no clear rationale for which agencies are included in the Act and which are not. ASIC notes in its submission that the application of the Public Service Act has unnecessarily limited ASIC's ability to recruit and utilise external staff.²⁷ Although the Inquiry recognises the need for regulators to maintain a culture of 'public service', this does not depend on coverage by the Public Service Act and can be achieved through tailored codes of conduct and statements of values. Removing ASIC from coverage by

24 See also: Senate Economics References Committee 2014, *Report on the Performance of the Australian Securities and Investments Commission*, Commonwealth of Australia, Canberra, pages 407–415; International Monetary Fund (IMF) 2012, *Australia: Financial System Stability Assessment*, IMF Country Report No.12/308, IMF, Washington, DC, page 26.

25 Over the last five years, less than 5 per cent of APRA staff members were recruited from the public service. APRA, Second round submission to the Financial System Inquiry, page 78.

26 Australian Financial Markets Association 2014, Second round submission to the Financial System Inquiry, page 52.

27 Australian Securities and Investments Commission 2014, Second round submission to the Financial System Inquiry, pages 75–77.

the Public Service Act would allow it to tailor management and staffing arrangements to suit its needs.

Capability

There is no formal process for keeping regulators fit for purpose by ensuring they have the skills, resources and powers to meet future challenges. At present, regulators are subject to regular review through the five-yearly International Monetary Fund Financial Sector Assessment Program. However, this has a strong focus on compliance with international standards and codes. Capability reviews are only undertaken on an ad hoc basis; for example, the Palmer Review into the role of APRA in the collapse of HIH. This is in contrast to the recent requirement for major Government agencies, including the ATO and the Australian Bureau of Statistics, to undertake periodic capability reviews. For APRA and ASIC, a six-yearly cycle would allow capability reviews to be aligned with every second funding review, allowing the two to take place concurrently.

Conclusion

Moving ASIC and APRA to a three-year budget model, giving them more operational autonomy and introducing six-yearly capability reviews would enhance the operation of the current regulatory framework. This is a particularly important issue for ASIC given the breadth of its responsibilities.

Given the extent of the changes the Inquiry has proposed for ASIC in this report, ASIC should be the first to undergo a capability review in 2015. This would help to ensure it has the skills and culture to carry out its enhanced role effectively.

Strengthening Australian Securities and Investments Commission's funding and powers

Recommendation 29

Introduce an industry funding model for Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.

Description

Government should recover the cost of ASIC's regulatory activities directly from industry participants through fees and levies calibrated to reflect the cost of regulating different industry sectors. Government would continue to set ASIC's overall funding needs. However, this would be done through three-yearly funding reviews.

Government should strengthen the Australian Credit Licence and Australian Financial Services Licence (AFSL) regimes so ASIC can deal more effectively with poor behaviour and misconduct. ASIC should be able to consider all relevant factors in determining whether or not a licence should be granted. ASIC approval should be required for material changes in the ownership or control of a licensee. Finally, ASIC should have more capacity to impose conditions requiring licensees to address concerns about serious or systemic non-compliance with licence obligations (including expert reviews).

The maximum civil and criminal penalties for contravening ASIC legislation should be substantially increased to act as a credible deterrent for large firms. ASIC should also be able to seek disgorgement of profits earned as a result of contravening conduct.

Objective

- Ensure ASIC has adequate funding and regulatory tools to deliver effectively on its mandate.

Discussion

Problems the recommendation seeks to address

Industry funding

At present, Government only recovers a small proportion of ASIC's costs directly from industry participants, through the Financial Institutions Supervisory Levies, application fees and fees for market supervision. The absence of industry funding means ASIC costs are not transparent to regulated industry participants. It also exposes ASIC to an increased risk of funding cuts that are unrelated to changes in the cost of delivering on its mandate. The Senate Economics References Committee report

on ASIC's performance highlighted that resource constraints affect ASIC's capacity to conduct surveillance across regulated entities.²⁸

Most of the revenue collected by ASIC on behalf of Government comes from annual fees paid by small proprietary companies as part of ASIC's registry business. These entities pay more than the cost of supervision. By contrast, the fees collected from large corporations, auditors, liquidators and financial institutions amount to less than the cost of regulating them, although some of this shortfall is offset by the money Government collects through the Financial Institutions Supervisory Levies administered by APRA.

The Wallis Inquiry recommended that both APRA and ASIC should be industry funded.²⁹ However, this recommendation was only adopted in relation to APRA. At that time, the revenue collected by ASIC on behalf of the Australian Government was required to be shared with the states.

Enforcement tools

Although ASIC's AFSL licensing powers were significantly strengthened in 2012, as part of the Future of Financial Advice law reforms, ASIC's submission notes that some gaps remain in its capacity to exclude persons who are not fit and proper from the industry:³⁰

- Ownership or control of licensees can change without the need to obtain approval from ASIC – or APRA, in the case of prudentially regulated entities. This problem was identified in relation to the collapse of Trio Capital. While the previous Government agreed to a recommendation by the Parliamentary Joint Committee on Corporations and Financial Services to address this issue, the law has not been changed.³¹
- The extent to which ASIC can consider previous conduct in other businesses in determining whether an applicant will satisfy the 'fit and proper' test is uncertain. This can limit its capacity to refuse a licence to applicants who have played a material role in businesses previously subject to enforcement action. This issue was

28 Senate Economics References Committee 2014, *Report on the Performance of the Australian Securities and Investments Commission*, Commonwealth of Australia, Canberra, pages 23–24.

29 Commonwealth of Australia 1997, *Financial System Inquiry Final Report*, Recommendation 107, Canberra, page 535.

30 Australian Securities and Investments Commission 2014, Second round submission to the Financial System Inquiry, page 46. This issue is also covered in *Chapter 4: Consumer outcomes*.

31 Parliamentary Joint Committee on Corporations and Financial Services 2012, *Inquiry into the Collapse of Trio Capital*, Commonwealth of Australia, Canberra, pages 127–128; Commonwealth of Australia 2013, *Government Response to the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the Collapse of Trio Capital*, Canberra, page 2.

Financial System Inquiry — Final report

identified in the Senate Economics References Committee's report on ASIC's performance.³²

- ASIC is limited in its capacity to use the licensing regime to impose conditions on firms to address concerns about internal systems relating to serious or systemic misconduct. At present, these can often only be imposed through enforceable undertakings with the agreement of the licensee.

As the Inquiry noted in its Interim Report, the maximum penalties in Australia for contravening laws governing financial sector conduct are low by international standards. For example, ASIC cannot seek disgorgement of profits in relation to civil contraventions.³³ As such, current penalties are unlikely to act as a credible deterrent against misconduct by large firms. While the Inquiry recommends substantially higher penalties, it does not believe that Australia should introduce the extremely high penalties for financial firms recently seen in some overseas jurisdictions. This practice risks creating inappropriate incentives for government and regulators unless revenue is separated and used for social or public purposes.

Conclusion

Few submissions comment on ASIC enforcement powers or the adequacy of the current penalty regime. Most discussion of ASIC enforcement powers focused on whether or not ASIC should regulate product manufacture and distribution, although there was some discussion of the balance between administrative remedies on the one hand, and enforceable undertakings and judicial remedies, such as civil and criminal penalties, on the other.³⁴ Some submissions specifically support substantially increasing maximum penalties.³⁵

Stronger enforcement of the current framework can reduce demands for new rules and regulations. This is a particularly important issue for ASIC given the breadth of its responsibilities. The main risk of the new arrangements is that they may impinge unfairly on the rights of industry participants. However, ASIC decisions in this area would continue to be subject to merits review.

Second round submissions are divided on the issue of whether Government should charge fees and levies that reflect the cost of ASIC's regulatory functions. Several

32 Senate Economics References Committee 2014, *Report on the Performance of the Australian Securities and Investments Commission*, Commonwealth of Australia, Canberra, pages 387–388.

33 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, pages 3-124 to 3-125.

34 Minter Ellison 2014, Second round submission to the Financial System Inquiry, page 9.

35 Law Council of Australia 2014, Second round submission to the Financial System Inquiry, Business Law Section, pages 7–8 and 10–12; Australian Shareholders' Association 2014, Second round submission to the Financial System Inquiry, page 1.

submissions support industry funding, while others were opposed to this option.³⁶ Remaining submissions that dealt with the issue support the concept of industry funding provided it is accompanied by stronger transparency and accountability mechanisms.³⁷ Others emphasise that Government, rather than regulators, should determine the overall quantum of funding.³⁸ One issue is whether ASIC's regulatory functions are 'public goods' that should be funded through general taxation. Although ASIC's regulatory functions reflect public policy objectives, the Inquiry does not believe this should prevent the introduction of industry funding. However, it may be inappropriate for particular functions, such as financial literacy. Industry funding is already used by APRA as well as many similar regulators overseas.³⁹

The main benefit of industry funding is its potential to give ASIC more predictable funding as well as strengthen engagement between ASIC and industry on the costs of conduct and market regulation. It would also have some potential costs. Depending on how they are designed, fees and levies have the potential to increase barriers to entry and potentially limit competition. One submission raises this concern in relation to existing cost recovery arrangements for market supervision.⁴⁰

To maximise its benefit, the funding model should be structured to create a close relationship between the incidence of fees and levies and the cost of regulating the relevant activity. Costs must also be attributed fairly across different firms and industry segments. The way in which industry funding is implemented may need to be tailored to different industry sectors.

The Inquiry expects the benefits of industry funding to exceed the costs, subject to careful implementation and inclusion of an appropriate transparency and accountability framework.⁴¹ It has sought to address stakeholder concerns about industry funding by ensuring Government would continue to set ASIC's budget. Recommended three-yearly reviews would bring additional rigour to the budget process, and improve the efficiency of the regulators.

36 Choice 2014, Second round submission to the Financial System Inquiry, page 25; EY 2014, Second round submission to the Financial System Inquiry, page 16; Stockbrokers Association of Australia 2014, Second round submission to the Financial System Inquiry, pages 13-15; SMSF Professionals Association of Australia 2014, Second round submission to the Financial System Inquiry, page 73.

37 For example, Australian Financial Markets Association 2014, Second round submission to the Financial System Inquiry, page 46; Insurance Council of Australia 2014, Second round submission to the Financial System Inquiry, page 15; Westpac Group 2014, Second round submission to the Financial System Inquiry, page 109.

38 Herbert Smith Freehills 2014, Second round submission to the Financial System Inquiry, ASIC Funding, supplementary submission; National Insurance Brokers Association 2014, Second round submission to the Financial System Inquiry, page 27.

39 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 3-112.

40 Chi-X Australia 2014, Second round submission to the Financial System Inquiry, pages 2-6.

41 Basic requirements are set out in Department of Finance 2014, *Australian Government Cost Recovery Guidelines, Resource Management Guide No. 304*, Commonwealth of Australia, Canberra.

Strengthening the focus on competition in the financial system

Recommendation 30

Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.

Description

Through their annual reports, regulators should demonstrate that they have given explicit consideration to trade-offs between competition and other regulatory objectives when designing regulations. The effect of regulatory proposals on competition should be explained explicitly in consultation documents and annual reports, which would then feed into Assessment Board examination of overall regulator performance.

Government should commission periodic external reviews of the state of competition in the financial system every three years, including regulatory barriers to foreign and domestic entrants.

As an immediate first step, regulators should examine their rules and procedures to assess whether those that create inappropriate barriers to competition can be modified or removed, or whether alternative and more pro-competitive approaches can be identified.⁴² Each regulator should report back to Government prior to the first external review of the state of competition.

Government should update ASIC's mandate to include a specific requirement to take competition issues into account as part of its core regulatory role.⁴³

These proposals are in addition to the recommendations in this report addressing sectoral issues in banking, payments and financial markets.

42 Some of this is underway. Australian Prudential Regulation Authority (APRA) stated in its second round submission that it is considering whether a more graduated approach to authorisation may be warranted for established foreign institutions. APRA 2014, Second round submission to the Financial System Inquiry, page 87.

43 The *Australian Securities and Investments Commission Act 2001* (ASIC Act) requires ASIC to promote commercial certainty and economic development and efficiency while reducing business costs. However, there is no explicit reference to competition in the ASIC Act (or the objects clause for Chapter 7 of the *Corporations Act 2001*).

Objectives

- Increase the focus on competition in the financial sector.
- Deliver more explicit reporting about the competition implications of regulatory decisions.
- Highlight areas where there may be opportunities to strengthen competition.

Discussion

Problem the recommendation seeks to address

The benefits of competition are central to the Inquiry's philosophy. While competition is generally adequate in the financial system at present, the high concentration and steadily increasing vertical integration in some sectors has the potential to limit the benefits of competition in the future. Licensing provisions and regulatory frameworks can impose significant barriers to the entry and growth of new players, especially those with business models that do not fit well within existing regulatory frameworks. Financial services businesses competing across national borders can find themselves subject to duplicated and sometimes conflicting obligations. In some cases, these rules reflect different local circumstances. However, they can limit competition in Australia as well as impede Australian-domiciled firms' ability to participate in global financial markets.

Australian Competition Law provides an economy-wide framework for promoting competition and addressing anti-competitive behaviour. However, the effectiveness of the framework depends on the ACCC's capacity to enforce its provisions – and the ACCC must prioritise its work across the entire economy. Also, Australian Competition Law does not provide a framework for removing regulatory barriers to competition through improved regulatory practices and rules.

At present, regulator mandates adopt an inconsistent approach to competition. The PSB has a clear competition objective. APRA is required to consider competition and contestability in its decisions, although the industry frameworks do not adopt a consistent approach to this issue. ASIC lacks an explicit competition mandate. Furthermore, there is no current requirement for regulators to explain how they balance competition considerations with other regulatory objectives in reaching decisions.⁴⁴

Finally, there is currently no process for regularly assessing the state of competition in the financial system, as there is for assessing stability in the form of the Financial Stability Review. This creates the risk that broader competition issues will 'fall between the cracks' as regulators focus on their specific mandates for stability or consumer

⁴⁴ The Interim Report noted this is currently done on an ad hoc basis: Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 3-122.

protection. For example, no regulator has direct responsibility for removing barriers to consumers switching products.

Conclusion

The recommendation would deliver a stronger focus on competition in the financial system. In the absence of change, there is a risk that regulators and policy makers will not place sufficient emphasis on competition when making decisions. This is a significant issue given the:

- Extent of market concentration in some parts of the system, and its potential to limit competition in the future.
- Disproportionate effect that regulation can have on smaller firms.
- Potential benefits to the Australian economy of disruptive innovation from new market entrants in the financial system, and improved depth and international connectivity of financial markets from cross-border competition.

The Inquiry considered two alternative options for strengthening the focus on competition: appoint an additional APRA member to focus on competition, or give the ACCC exclusive responsibility for competition matters (that is, remove it from the mandates of APRA and ASIC). In relation to the first option, the Inquiry concluded that strengthening consideration of competition issues as part of ordinary regulatory processes was likely to have more effect than appointing a separate competition member.

In relation to the second, the Inquiry considered it would be counterproductive to remove competition and efficiency considerations from the mandates of APRA and ASIC because this would reduce pressure on them to consider these issues. The ACCC also lacks the power to intervene in regulation making by APRA or ASIC. Its focus is on enforcing the prohibitions against anti-competitive conduct by businesses in Australian Competition Law.

Compliance costs and policy processes

Recommendation 31

Increase the time available for industry to implement complex regulatory change.

Conduct post-implementation reviews of major regulatory changes more frequently.

Description

Except in exceptional circumstances, Government and regulators should give industry participants at least six months to begin implementing regulatory changes once they are finalised. Additional transitional periods of 12–24 months will also generally be appropriate. Grouping commencements at fixed dates during the year – for example, 1 July and 1 January – would help industry participants to accommodate overlaps between related changes, rather than having to make multiple system changes.

Government and regulators should also carry out more post-implementation reviews of major changes to analyse their cost effectiveness and help develop better processes for future interventions.

This proposal is consistent with Government's recently announced Regulator Performance Framework, which requires post-implementation reviews for regulatory changes that have a major economic effect. The Inquiry's recommendations on accountability and competition are also expected to improve policy processes and focus policy makers and regulators on considering compliance costs and efficiency implications.

Objective

- Reduce costs, complexity and unanticipated negative implications associated with implementing regulatory change.

Discussion

Problem the recommendation seeks to address

Most industry submissions identified the scope and pace of domestic regulatory change in the post-GFC environment as a major issue. This is partly due to factors beyond Australia's direct control, including the proliferation of global standard-setting under the auspices of the Financial Stability Board in the wake of the crisis. Another factor is the wave of domestic regulatory change in countries that were at the epicentre of the crisis, substantially affecting Australian firms with an international presence. However, these developments have occurred at the same time as major domestically

Financial System Inquiry — Final report

driven changes to the regulation of credit, financial advice, general and life insurance, and superannuation.

The Inquiry has not sought to examine all regulation with a view to identifying deregulation opportunities. However, the Inquiry commissioned Ernst & Young (EY) to assess the cost effectiveness of regulatory processes for three initiatives: changes to the presentation of credit card terms and conditions; the 'know your customer' (KYC) requirements of Australia's anti-money laundering (AML) framework; and the three-day balance transfer requirement for superannuation funds included in the SuperStream reforms.

EY's conclusion was that Government can, "... improve medium-term outcomes of regulatory intervention through incremental changes in how it designs and implements additional measures and how it monitors the impact (including unintended effects) of regulation that has been implemented".⁴⁵ Although overall policy settings may be appropriate, the report identified some shortcomings in how policies are operationalised, including:

- In some cases, it is not clear that detailed costs and benefits of changes have been considered.
- There are gaps in industry consultation processes; for example, they may occur too late to allow for efficient planning.
- Implementation deadlines can be optimistic.

The EY report highlighted the difficulties associated with undertaking cost-benefit analysis of regulatory interventions. In particular, it noted that governments undertake interventions for a mix of short- and long-term objectives and that assessing benefits is more difficult than assessing direct costs. Timing issues are also relevant in that costs may be readily apparent in the short-term, yet benefits may only emerge over a longer period. For this reason, EY suggested that better upfront cost effectiveness analysis would be an appropriate alternative to a full cost-benefit analysis, particularly where timeframes are short.

Improved cost effectiveness analysis could include up-front projections of the expected effects, early consultation on costs, and then post-implementation monitoring of actual effect and costs, with review points triggered where changes have materially lower effects or materially higher costs. Specific findings related to the three initiatives studied by EY are set out in *Box 13: EY cost effectiveness analysis of regulatory interventions*.

⁴⁵ EY 2014, *Financial System Regulation*, data provided to the Financial System Inquiry, October 2014, page 2.

Box 13: EY cost effectiveness analysis of regulatory interventions

Reforms to the presentation of credit card terms and conditions are estimated to have involved total implementation costs of between \$40 million and \$120 million across the industry. EY found some changes to consumer behaviour and associated savings did follow the reforms; however, it could not conclude with certainty that the changed behaviour was the result of the reforms. EY noted it was not clear whether the Commonwealth had undertaken detailed consideration “... of how to best target different consumer segments through the overall dispersion of additional information on credit card terms”.⁴⁶ This example highlights the importance of a transparent cost-benefit or cost effectiveness process.

KYC requirements are estimated to have cost between \$647 million and \$1 billion to implement, with ongoing annual costs of between \$299 million and \$435 million. The changes are driven by the need to comply with international regulatory standards. Although participants agreed AML legislation is essential, consultations highlighted, “... earlier consultation on coverage and structure would have produced more efficient regulation”.⁴⁷

The **three-day balance transfer** requirement introduced as part of **SuperStream** was estimated to have cost industry between \$560 million and \$1.2 billion. EY noted that regulation in this area was a response to industry’s failure to adopt effective electronic payment protocols. However, the industry view was that Government’s approach generated some additional costs. In particular, consultation did not start early enough and implementation deadlines were optimistic. Tight deadlines meant that solutions were implemented in a less than optimal way to ensure timelines were met. A more risk-based approach from the Commonwealth, with more time for industry to develop data requirements and format standards, would have produced a more efficient outcome.

The EY work reinforced some of the main points in industry submissions, where industry participants asked for better regulatory design and more realistic implementation time frames.⁴⁸ In general, better processes for the future are a higher priority in the short term than efforts to reduce the current stock of regulation.

Despite concerns related to processes arising from this work, the Inquiry has found limited evidence to suggest the compliance burden is higher in Australia than in comparable peer countries. The Australian Bankers’ Association submission highlighted that, according to the World Economic Forum’s *Global Competitiveness Report 2013–14*, Australia ranks 128th out of 148 countries for “Burden of government

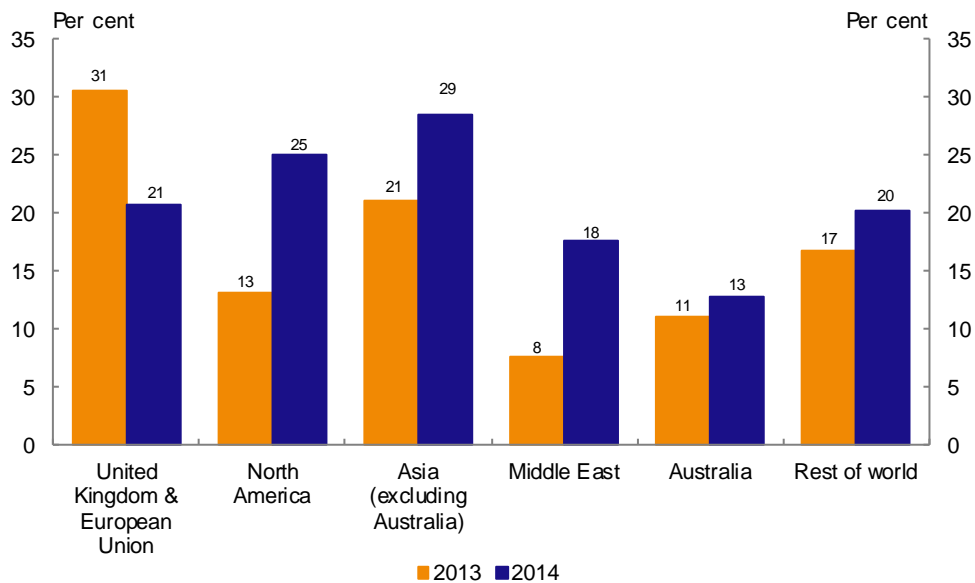
46 EY 2014, Financial System Regulation, data provided to the Financial System Inquiry, October 2014, page 26.

47 EY 2014, Financial System Regulation, data provided to the Financial System Inquiry, October 2014, page 33.

48 Australian Bankers’ Association 2014, Second round submission to the Financial System Inquiry, pages 63–68, ANZ 2014, Second round submission to the Financial System Inquiry, page 28.

regulation”.⁴⁹ However, in addition to the evidence set out in the Interim Report, cost of compliance survey data provided by Thomson Reuters Accelus suggests that, although compliance costs for the financial sector have risen in Australia recently, Australia is not out of step with other jurisdictions.

Chart 7: Financial services firm compliance teams spending more than 10 hours per week tracking finance sector regulatory developments



Source: Thomson Reuters Accelus.⁵⁰

Conclusion

Regardless of Australia’s relative position, unnecessary compliance costs and poor policy processes are a concern. The Inquiry notes that Government has already implemented a range of initiatives in this area, including more stringent requirements relating to RISs, sunseting provisions for existing regulations, portfolio targets for reducing compliance costs and the Regulator Performance Framework.

Combined with Government’s existing initiatives to reduce ‘red tape’ and a slowing in the pace of international regulation, the Inquiry’s recommendations should address many of the concerns raised in industry submissions.

⁴⁹ Australian Bankers’ Association 2014, Second round submission to the Financial System Inquiry, page 63.

⁵⁰ Thomson Reuters Accelus 2014, data provided to the Financial System Inquiry, 7 October 2014.

Appendix 1: Significant matters

The Inquiry has recommendations on a number of additional significant matters.

Funding

Impact investment

Recommendation 32

Explore ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery.

Provide guidance to superannuation trustees on the appropriateness of impact investment.

Support law reform to classify a private ancillary fund as a 'sophisticated' or 'professional' investor, where the founder of the fund meets those definitions.

Impact investing allows investors to pursue opportunities that provide both social and financial returns. This innovative form of funding is growing globally as a valuable mechanism to support social service delivery. Changing community expectations about the role of government and the financial sector in funding social service delivery highlight a need for this funding mechanism in Australia.

Impact investment can occur through direct investment in not-for-profit or social enterprises. Alternatively, it can be intermediated by community development financial institutions, social banks and impact investment fund managers. These intermediaries play a valuable role in channelling impact investment funds as well as building capacity in not-for-profit and social enterprises to attract impact investment funds.

Importantly, impact investing has the potential to benefit government and taxpayers by reducing costs and improving social policy outcomes. It can change the role of Government from paying for inputs to paying for outcomes. It can also benefit not-for-profits by diversifying their funding sources and helping them to develop technical expertise in benchmarking and measuring outcomes, as well as improving governance and accountability.

Financial System Inquiry — Final Report

Given the potential benefits of social impact investment and its current limited use in Australia, the Interim Report sought feedback on market impediments. The Inquiry agrees with stakeholders who suggest that clarifying some aspects of regulation would facilitate market development, including:

- Clearer guidance from the Australian Prudential Regulation Authority (APRA) on the appropriateness of impact investment for superannuation trustees. Currently, guidance is limited.
- Government should amend the law to facilitate private ancillary funds established and controlled by ‘sophisticated’ or ‘professional’ investors accessing wholesale offerings for social impact bonds.¹

Many stakeholders argue that Government should play a more active role to facilitate the social impact investment market in Australia, although views vary on the nature of this role.² The Inquiry agrees “Government intervention can play a catalytic role both in facilitating the functioning of the ecosystem and targeting actions to trigger its further development. However, these actions should provide incentives for the engagement, not the replacement of the private sector and should be conducted in a manner conducive of the market”.³

The Inquiry sees merit in Government facilitating the impact investment market. Government’s involvement should include coordinating interested private sector parties, providing expertise on social service delivery and performance measurement, and offering explicit public endorsement for the significant private sector interest in this emerging market.

1 Impact Investment Group 2014, Second round submission to the Financial System Inquiry, pages 6–7.

2 Westpac 2014, Second round submission to the Financial System Inquiry, page 50; Impact Investing Australia 2014, Second round submission to the Financial System Inquiry, page 5; Impact Investment Group 2014, Second round submission to the Financial System Inquiry, page 9.

3 Impact Investing Australia 2014, Second round submission to the Financial System Inquiry, page 10 citing: Organisation for Economic Co-operation and Development (OECD) 2011, *Financing high-growth firms: the role of angel investors*, OECD, Paris, page 124.

Retail corporate bond market

Recommendation 33

Reduce disclosure requirements for large listed corporates issuing 'simple' bonds and encourage industry to develop standard terms for 'simple' bonds.

Australia has an established domestic bond market. However, a range of constraints, including tax and regulatory settings, have limited the market's development – in particular, the retail corporate bond market. The Interim Report discusses these issues further.⁴

For corporates, the disclosure requirements for a retail corporate bond issue are more onerous and costly than for domestic wholesale issuance. Although the new 'simple' corporate bonds legislation reduces the cost of disclosure documentation, it is still greater than for a domestic wholesale issue.⁵ Less onerous disclosure requirements for listed securities would make retail issuance simpler and more cost effective.

The Inquiry considers that Government should amend the law to reduce disclosure requirements for large listed corporate issuers of 'simple' bonds. The disclosure regime should comprise a term sheet for a standardised product and a cleansing notice. In addition, industry – assisted by the Australian Financial Markets Association – should develop standard terms and conditions for 'simple' bonds, which would also help reduce disclosure costs. The Inquiry believes that the proposed regime would strike the right balance between reducing issuance costs and providing potential investors with sufficient information to make a considered investment decision.

Stakeholders generally agree, and suggest that the documentation costs would be broadly aligned with those for domestic wholesale issuance.⁶ Given the proposed disclosure regime is similar to current requirements for a domestic wholesale issue, it would also reduce the administrative burden of a retail offer associated with a wholesale issue.

Broadly, submissions and stakeholders agree that, at least initially, the new disclosure regime should not be available to smaller corporates on the listed equity market. In

4 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, pages 2-86 to 2-87.

5 The *Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014* became law on 11 September 2014. The regime is not fully implemented, as much of the structure and content of disclosure requirements are to be set by regulation and have only recently been released for public consultation.

6 Based on an industry survey conducted by the Australian Financial Markets Association (AFMA). AFMA 2014, Data provided to the Financial System Inquiry, 1 October 2014.

Financial System Inquiry — Final Report

general, investors have the benefit of more market research and publicly available information for larger corporates. Larger corporates are also more likely to be repeat issuers and thus be subject to market discipline regarding the quality of their disclosures.

The Inquiry considers that the new regime should only be available to the top 150 companies by market capitalisation on the Australian Securities Exchange (ASX). This is broadly consistent with the views of stakeholders. Government should review this limit after two years to determine whether the regime should be extended to smaller corporates.

Unfair contract term provisions

Recommendation 34

Support Government's process to extend unfair contract term protections to small businesses.

Encourage industry to develop standards on the use of non-monetary default covenants.

Protections from unfair contract term (UCT) provisions under the *Australian Securities and Investments Commission Act 2001* currently do not apply to small business loans or business-to-business lending. The UCT provisions are limited to consumer contracts: those in which at least one party is an individual acquiring goods or services wholly or predominantly for personal, domestic or household use or consumption.

Several submissions suggest that some non-monetary loan covenants are unfair and lenders could be more transparent when exercising them.

The Inquiry supports Government's public consultation and policy development process for extending the coverage of UCT protections under standard form contracts to small businesses. Although such protections would not prevent unfair terms in non-standard contracts, the Inquiry believes this approach may improve broader contracting practices and the fair exercise of rights pursuant to non-monetary default covenants. The Australian Securities and Investments Commission (ASIC) could also make protections more effective by clarifying its intent to enforce UCT provisions.

More broadly, the Inquiry encourages the banking industry to adjust its code of practice to address non-monetary default covenants. The Code of Banking Practice and the Customer Owned Banking Code of Practice could require banks to give borrowers sufficient notice of changes to covenants and of an intention to enforce – which could give a borrower reasonable time to obtain alternative financing. Such adjustments to industry practice would also provide greater scope and guidance for the Code Compliance Monitoring Committee and the Financial Ombudsman Service to deal with relevant complaints.

Finance companies

Recommendation 35

Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from authorised deposit-taking institution deposits.

Finance companies operate under an exemption from the *Banking Act 1959*. They differ from authorised deposit-taking institutions (ADIs) because they raise funds by issuing debt securities rather than by accepting deposits. Although most Australian finance companies source their funding from wholesale investors, some smaller entities target consumers. The period since the global financial crisis has seen numerous failures of finance companies, resulting in significant losses. In the wake of these failures, it has become apparent that some consumers did not appreciate the difference between finance companies and ADIs.⁷ This problem was exacerbated by finance companies using bank account-like terminology and allowing consumers to access funds at call.

The Inquiry considered whether to ban finance companies from accepting retail funds from consumers. However, it recognises that well-run finance companies can play a useful role in the market. It also considered whether they should be prudentially regulated by ASIC – an approach considered by the former Government following the collapse of Banksia Securities. However, the Inquiry does not recommend that ASIC's mandate be extended in this way. The Inquiry considers that the best approach would be to differentiate the products of finance companies from accounts offered by ADIs. The Inquiry therefore recommends APRA ban finance companies from offering at-call products to retail consumers and from using bank account-like terminology.

Corporate administration and bankruptcy

Recommendation 36

Consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.

The Interim Report asked stakeholders about the efficiency of Australia's external administration regime.⁸ Submissions indicate that Australia's external administration provisions are generally working well and do not require wholesale revision.

7 Australian Prudential Regulation Authority 2014, First round submission to the Financial System Inquiry, page 83.

8 Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 2-69.

Financial System Inquiry — Final Report

Stakeholders present little evidence to suggest the Australian regime causes otherwise viable businesses to fail. However, submissions highlight that a few elements of the United States Bankruptcy Code's Chapter 11 insolvency framework merit consideration.⁹

Submissions argue that directors should be protected by 'safe harbour' provisions that permit restructuring efforts for firms in financial difficulty without invoking external administration processes. These protections would only apply where directors seek expert assistance. Stakeholders also suggest extending the safe harbour protection to the expert restructuring advisers to prevent them from being considered de facto directors. Further, stakeholders suggest that ipso facto clauses be suspended from operating during the restructuring efforts.¹⁰

The Inquiry recognises more work needs to be done to assess the potential value of these proposals and recommends Government conducts stakeholder consultation on these matters.

The current Australian external administration regime has other complexities:

- In some cases, external administration and bankruptcy processes overlap, causing disproportionate complexity and cost. This particularly affects small and medium-sized enterprises, where the owner faces personal bankruptcy if their incorporated business fails.
- Complaints and dispute resolution processes relating to the external administration regime could be improved. ASIC is currently implementing measures to enhance existing processes.
- Elements of external administration and bankruptcy regulation are not technology neutral and efficiencies available from digital processes are not being used.

Government consultation has commenced on measures to address elements of the first two of these issues. *Recommendation 39: Technology neutrality* in this appendix addresses the third.

9 Chapter 11 refers to "... the chapter of the US Bankruptcy Code providing (generally) for reorganisation, usually involving a corporation or partnership". United States Courts, *Reorganization under the Bankruptcy Code*, United States Courts, Washington, DC, viewed 23 October 2014, <<http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter11.aspx>>.

10 Ipso facto clauses deem a company to be in default in circumstances approaching insolvency; for instance, where there has been a 'material adverse change' in a company's financial circumstances. Corporations and Markets Advisory Committee (CAMAC) 2003, *Rehabilitating large and complex enterprises in financial difficulties*, CAMAC, Sydney, paragraph 1.44, page 9.

Superannuation and retirement incomes

Superannuation member engagement

Recommendation 37

Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance.

Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.

Research indicates that giving consumers retirement income projections improves their engagement with saving for retirement.¹¹ However, many superannuation funds do not provide retirement income projections on member statements. All members need to understand their projected retirement income to make informed decisions about their retirement savings. Where possible, all funds should provide meaningful retirement income projections on member statements, including scenarios to alert members to sequencing risk, based on the standard assumptions described in ASIC's requirements for superannuation forecasts.¹² This would benefit members at a relatively small cost to superannuation funds.

Superannuation funds can only provide a partial perspective of retirement incomes for members who have multiple accounts and wealth accumulated outside of superannuation. Online calculators enable individuals to enter all their information – superannuation fund and asset balances – to obtain a more accurate retirement income projection, including any income from the Age Pension. The Australian Taxation Office (ATO), which holds consolidated superannuation information across multiple accounts, could provide that information for use in calculators, which could initially be accessed from the ATO's myGov superannuation portal. This would assist funds to design calculators that provide retirement income projections based on the comprehensive income product for retirement they offer members (see *Recommendation 11: The retirement phase of superannuation* in Chapter 2).

11 Goda, G, Manchester, C, Sojourner, A 2012, What's my account really worth? The effect of lifetime income disclosure on retirement savings, *National Bureau of Economic Research, Working Paper No. 17927*.

12 Australian Securities and Investments Commission (ASIC) 2014, *Regulatory Guide 229: Superannuation forecasts*, ASIC, Sydney.

There would be small implementation costs for the ATO to link its existing myGov superannuation portal to retirement income calculators.

Innovation

Cyber security

Recommendation 38

Update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation, and progress public-private sector and cross-industry collaboration.

Establish a formal framework for cyber security information sharing and response to cyber threats.

As observed in the Interim Report, cyber attacks are increasing in frequency and sophistication.¹³ The financial industry is a major target of cyber crime and is under increasing threat as the number of high-value targets in the sector grows. Major industry participants raise cyber security as a significant risk to their viability and to the financial system. A financial sector cyber crisis could result in system-wide impacts and significant consumer detriment.

The growth in interconnectivity, increasing network speeds and broad distribution of technology mean that responses to cyber threats by individual institutions are necessary but, in some cases, insufficient. Many industry participants suggest the cyber security of the financial system is only as strong as its 'weakest link', requiring efforts by both Government and industry to strengthen capacity to respond in an effective and coordinated way.

Australia has a Cyber Security Strategy (CSS) in place, released in 2009, that outlines a whole-of-Government cyber security policy. Submissions indicate the CSS is out of date and not suited to today's threat environment. Given the rapidly changing nature of cyber space and the threat environment, Government should act to ensure Australia has an updated and cohesive CSS.

Industry participants indicate that, although they already actively monitor the threat environment and are well placed to identify vulnerabilities, the most effective responses come from combining the intelligence they hold with timely threat

¹³ Commonwealth of Australia 2014, *Financial System Inquiry Interim Report*, Canberra, page 4-55.

information held by Government. Consequently, policy and regulatory frameworks need to support effective and timely public-private sector information sharing.

Given the constant and rapid evolution of cyber threats, public-private sector coordination of cyber crisis planning – including across sectors (for example, with the telecommunications sector) – is becoming increasingly important. Industry participants in particular highlight a need to clarify the roles of the public and private sectors in a cyber crisis event to ensure a rapid, coordinated and effective response.

Updating the CSS, developing formal mechanisms for public-private sector information sharing and clarifying public and private sector roles in a cyber crisis would help to improve the resilience of the financial system. It would better prepare the financial sector, Government and other industry sectors to respond in a timely and coordinated manner to evolving cyber threats.

Technology neutrality

Recommendation 39

Identify, in consultation with the financial sector, and amend priority areas of regulation to be technology neutral.

Embed consideration of the principle of technology neutrality into development processes for future regulation.

Ensure regulation allows individuals to select alternative methods to access services to maintain fair treatment for all consumer segments.

Some regulation assumes or requires the use of certain forms of technology. For example, regulation may specify certain delivery mechanisms for products, or use terminology that assumes a paper-based environment. In other cases, new technologies put the operation of certain provisions in doubt. These circumstances can impede innovation and efficiency by preventing the uptake of new technologies that could provide better outcomes for users, businesses and government. They can also prevent government and regulators from managing risks appropriately.

Stakeholders have identified a range of priority areas for amendment, including regulation relating to financial products and services disclosure, customer consent and authorisation, payments and cheques, external administration processes, conveyancing and identity verification.¹⁴

¹⁴ Including: Mercer 2014, Second round submission to the Financial System Inquiry, pages 57-58; King & Wood Malletsons 2014, Second round submission to the Financial System

Financial System Inquiry — Final Report

Government should establish an industry working group to identify the priority areas of regulation to be amended for technology neutrality. A number of stakeholders have indicated their support for and willingness to be involved in such an initiative.¹⁵

Technology-neutral regulation enables any mode of technology to be used and tends to be competitively neutral. Generally, regulation should be principles-based and functional in design, focusing on outcomes rather than prescribing the method by which it should be achieved. However, the Inquiry recognises that technology specific regulation may continue to be required and be beneficial in cases where adopting a common technology standard would improve overall system efficiency. In these cases, future review mechanisms should be established to ensure technology-specific regulation does not impede innovation.

The principle of technology neutrality should be incorporated into government policy-making guides, and processes for developing future regulation. The guidance should allow for technology-specific regulation on an exceptions basis.

A technology-neutral approach to regulation enables regulators and government to adapt to innovative developments and manage risks. It can also reduce compliance costs by removing unnecessary regulatory impediments and improving the stability and longevity of regulation. It can also give financial product providers greater flexibility to innovate to meet changing consumer expectations.

Stakeholders note a potential consequence of technology-neutral regulation is that it risks excluding some community segments from the financial system.¹⁶ For example, by enabling businesses to shift to electronic service delivery as a default, older Australians or others with limited internet access may become excluded. As a result, it is important that regulation accommodates the ability of consumers to select alternative methods to access services, such as paper-based delivery.

In implementation, a phased approach may be required to manage transitional costs to industry. However, the Inquiry believes these costs would be outweighed by the longer-term efficiency benefits to industry and improved consumer outcomes.

Inquiry, pages 33–34; PEXA (Property Exchange Australia) 2014, Second round submission to the Financial System Inquiry, pages 7–9; Australian Restructuring Insolvency and Turnaround Association 2014, Second round submission to the Financial System Inquiry (main document), page 3.

15 Commonwealth Bank 2014, Second round submission to the Financial System Inquiry, page 60.

16 Refer, for example, to National Seniors Australia 2014, Second round submission to the Financial System Inquiry, page 29.

Consumer outcomes

Provision of financial advice and mortgage broking

Recommendation 40

Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.

The current regulatory framework addresses advice on financial products. The framework makes an important distinction between personal and general advice:

- **Personal advice** takes account of a person's needs, objectives or personal circumstances, whereas general advice does not.
- **General advice** includes guidance, advertising, and promotional and sales material highlighting the potential benefits of financial products. It comes with a disclaimer stating that it does not take a consumer's personal circumstances into account.

However, consumers may misinterpret or excessively rely on guidance, advertising, and promotional and sales material when it is described as 'general advice'. The use of the word 'advice' may cause consumers to believe the information is tailored to their needs. Behavioural economics literature and ASIC's financial literacy and consumer research suggests that terminology affects consumer understanding and perceptions.¹⁷

Often consumers do not understand their financial adviser's or mortgage broker's association with product issuers. This association might limit the product range an adviser or broker can recommend from.¹⁸ Of recently surveyed consumers, 55 per cent of those receiving financial advice from an entity owned by a large financial institution (but operating under a different brand name) thought the entity was independent.¹⁹

17 Australian Securities and Investments Commission (ASIC) 2013, *Report 378: Consumer testing of the MySuper product dashboard*, ASIC, Sydney, page 22; ASIC 2013, *Report 341: Retail investor research into structured capital protected and capital guaranteed investments*, ASIC, Sydney; Susan Bell Research 2008, *The provision of consumer research regarding financial product disclosure documents*, Financial Services Working Group, Sydney.

18 ASIC's review of Future of Financial Advice reform implementation observed that approximately 63 per cent of licensees in the sample tested were affiliated with financial product issuers. Australian Securities and Investments Commission (ASIC) 2014, *Report 407: Review of the financial advice industry's implementation of the FOFA reforms*, ASIC, Sydney, page 19.

19 In contrast, only 14 per cent of consumers considered financial planners working under the brand of the same financial institution to be independent. Roy Morgan Research 2014, data provided to the Financial System Inquiry, 7 November 2014.

Financial System Inquiry — Final Report

The Inquiry believes greater transparency regarding the nature of advice and the ownership of advisers would help to build confidence and trust in the financial advice sector. In particular, ‘general advice’ should be replaced with a more appropriate, consumer-tested term to help reduce consumer misinterpretation and excessive reliance on this type of information. Consumer testing will generate some costs for Government, and relabelling will generate transitional costs for industry – although these are expected to be small. The Inquiry believes the benefits to consumers from clearer distinction and the reduced need for warnings outweigh these costs.

Although stakeholders have provided little evidence of differences in the quality of advice from independent or aligned and vertically integrated firms, the Inquiry sees the value to consumers in making ownership and alignment more transparent. In particular, these disclosures should be broader than Financial Services Guide and Credit Guide rules currently require, and could include branded documents or materials. The Inquiry believes the benefits to consumers would outweigh the transitional costs to industry of effecting branding changes.

Unclaimed monies

Recommendation 41

Define bank accounts and life insurance policies as unclaimed monies only if they are inactive for seven years.

At present, bank accounts and life insurance policies are deemed to be unclaimed monies and transferred to Government if they are inactive for three years. The present position was changed in 2012, from a longstanding arrangement that required an inactive period of seven years.

The Australian Bankers’ Association estimates that reverting to seven years would halve the number of claims.²⁰ The Inquiry believes Government should act to ensure bank accounts and life insurance policies are deemed unclaimed after seven years of inactivity and that these monies should be held in a separate trust account.

²⁰ Australian Banker’s Association 2014, Submission in response to the Treasury discussion paper: *Options for Improving the Unclaimed Bank Account and Life Insurance Money Provisions*, page 2.

Regulatory system

Managed investment scheme regulation

Recommendation 42

Support Government's review of the Corporations and Markets Advisory Committee's recommendations on managed investment schemes, giving priority to matters relating to:

- *Consumer detriment, including illiquid schemes and freezing of funds*
- *Regulatory architecture impeding cross-border transactions and mutual recognition arrangements*

The Inquiry received relatively few submissions on managed investment scheme (MIS) matters, possibly due to other related and concurrent Government consultations.

In 2012, following a series of high-profile scheme collapses, the Corporations and Markets Advisory Committee (CAMAC) released a report into MISs that identified problems in a range of areas, including arrangements for restructuring or winding up failed schemes.^{21,22} The report also highlighted more fundamental concerns about schemes being used as vehicles for entrepreneurial activities rather than as passive investment vehicles. It found that most problems with the sector had arisen due to stress in 'common enterprise' schemes, where the MIS structure is favoured over the corporate structure for tax reasons. This in turn led to a number of difficulties in managing the financial distress of those schemes and consequent consumer detriment.

In 2014, CAMAC released a broad-ranging discussion paper that, among other issues, identified MIS regulatory architecture characteristics that impede other jurisdictions from recognising the equivalence of the Australian regulatory regime. Without equivalence, companies find it harder to conduct cross-border business.²³

Submissions received were largely about these issues. Accordingly, the Inquiry believes these should be priority areas for Government action arising from CAMAC's work.

21 Collapses were experienced primarily in the agribusiness sector.

22 Corporations and Markets Advisory Committee (CAMAC) 2012, *Managed investment schemes*, CAMAC, Sydney.

23 Corporations and Markets Advisory Committee (CAMAC) 2014, *The establishment of managed investment schemes*, CAMAC, Sydney.

Financial System Inquiry — Final Report

In addition to this recommendation, the Inquiry is making several other recommendations affecting the MIS sector, including:

- Strengthening regulators' focus on competition in the financial system, including identifying barriers to cross-border provision of financial services.
- Prioritising the rationalisation of MIS legacy products (see below).
- Removing regulatory impediments to innovative product disclosure and communication with consumers.

The Inquiry also identifies a number of taxes for consideration as part of the Tax White Paper process, such as the tax treatment of funds management vehicles (for further detail, see *Appendix 2: Tax summary*).

Legacy products

Recommendation 43

Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.

Industry estimates suggest that approximately 25 per cent of all funds under management are in legacy products.²⁴ These are products that are closed to new investors and have become uneconomic or rendered out of date by changes to market structure, Government policy or legislation. Legacy products increase costs to fund managers and life insurers. They can also prevent consumers from accessing better features in newer products.

Between 2007 and 2010, Government worked with industry to develop a mechanism to facilitate product rationalisation, focusing on the managed investments and life insurance sectors – superannuation was considered less problematic as there was already a successor fund transfer mechanism in relevant legislation. However, Government did not finalise or implement the mechanism.

The mechanism would have facilitated rationalisation of genuine legacy products – that is, not simply those that are performing poorly – subject to a 'no disadvantage test' for relevant consumers. It would also have provided tax relief to ensure consumers were not disadvantaged as a result of triggering an early capital gains tax event.

²⁴ Financial Services Council (formerly Investment and Financial Services Association Ltd) 2009, Second round submission to Australia's Future Tax System Review, page 5.

The Inquiry sees benefit in such a mechanism for product rationalisation that treats consumers fairly. Given the cost of implementing the mechanism, the Inquiry considers it should initially be limited to managed investments and life insurance, and that it should be subject to a cost recovery mechanism, such as an application fee. The application fee could be designed to offset process administration costs and incorporate economic incentives to ensure rationalisation targets the most problematic areas.

Corporations Act 2001 ownership restrictions

Recommendation 44

Remove market ownership restrictions from the Corporations Act 2001 once the current reforms to cross-border regulation of financial market infrastructure are complete.

An additional restriction on the ASX's ownership, over and above the Foreign Investment Review Board national interest test, was introduced on the exchange's demutualisation in 1998. The rationale for this restriction was concern about a possible conflict of interest in the ASX's role as a market co-regulator. However, responsibility for market supervision has now been transferred to ASIC, and proposals are underway to allow for stronger cross-border regulation.²⁵

Government should act to remove market ownership restrictions for the ASX to make it subject to the same ownership restrictions as other entities in the financial sector.

25 Council of Financial Regulators (CFR) 2014, *Application of the Regulatory Influence Framework for Cross-border Central Counterparties*, CFR, Sydney; Reserve Bank of Australia (RBA) and Australian Securities and Investments Commission 2012, *Implementing the CPSS-IOSCO Principles for financial market infrastructures in Australia*, RBA, Sydney; Stevens, G 2012, *Review of Financial Market Infrastructure Regulation*, letter to the Hon. Wayne Swan, MP (Deputy Prime Minister and Treasurer), 10 February.

Appendix 2: Tax summary

The Inquiry has identified a number of taxes that distort the allocation of funding and risk in the economy. The Inquiry also identified other tax issues that may adversely affect outcomes in the financial system. Unless they are already under active Government consideration, the tax issues listed below should be considered as part of the Tax White Paper process.

Issue	
Differentiated tax treatment of savings	<p>The tax system treats returns from some forms of saving more favourably than others. For example, interest income from bank deposits and fixed-income securities are taxed relatively heavily. This distorts the asset composition of household balance sheets and the broader flow of funds in the economy.</p> <p>To the extent that tax distortions direct savings to less productive investment opportunities, a more neutral tax treatment would likely increase productivity.</p> <p>The relatively unfavourable tax treatment of deposits and fixed-income securities makes them less attractive as forms of saving and increases the cost of this type of funding.</p>
Negative gearing and capital gains tax	<p>Capital gains tax concessions for assets held longer than a year provide incentives to invest in assets for which anticipated capital gains are a larger component of returns. Reducing these concessions would lead to a more efficient allocation of funding in the economy.</p> <p>For leveraged investments, the asymmetric tax treatment of borrowing costs incurred in purchasing assets (and other expenses) and capital gains, can result in a tax subsidy by raising the after-tax return above the pre-tax return. Investors can deduct expenses against total income at the individual's full marginal tax rate. However, for assets held longer than a year, nominal capital gains, when realised, are effectively taxed at half the marginal rate. All else being equal, the increase in the after-tax return is larger for individuals on higher marginal tax rates.</p> <p>The tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment. Since the Wallis Inquiry, higher housing debt has been accompanied by lenders having a greater exposure to mortgages. Housing is a potential source of systemic risk for the financial system and the economy.</p>
Dividend imputation	<p>The case for retaining dividend imputation is less clear than in the past. To the extent that dividend imputation distorts the allocation of funding, a lower company tax rate would likely reduce such distortions.</p> <p>By removing the double taxation of corporate earnings, the introduction of dividend imputation (in 1987) reduced the cost of equity and the bias towards debt funding. This contributed to the general decline in leverage among non-financial corporates.</p> <p>However, the benefits of dividend imputation, particularly in lowering the cost of capital, may have declined as Australia's economy has become more open and connected to global capital markets. If global capital markets set the (risk-adjusted) cost of funding, then dividend imputation acts as a subsidy to domestic equity holders. That would create a bias for domestic investors, including superannuation funds, to invest in domestic equities. Imputation provides little benefit to non-residents that invest in Australian corporates.</p> <p>For investors (including superannuation funds) subject to low tax rates, the value of imputation credits received may exceed tax payable. Unused credits are fully refundable to these investors, with negative consequences for Government revenue.</p> <p>Mutuals cannot distribute franking credits, unlike institutions with more traditional company structures. This may adversely affect mutuals' cost of capital, with implications for competition in banking.</p>

Issue	
Interest withholding tax (IWT)	<p>For non-residents, repatriated income from Australian investments is, in some cases, subject to withholding tax. The unequal tax treatment of repatriated income may affect the funding decisions of Australian entities and place Australia at a competitive disadvantage internationally.</p> <p>Lower, more uniform withholding tax rates would unwind these distortions; however, since withholding taxes help protect the integrity of the tax system, reforms should consider the potential implications for tax avoidance.</p> <p>Withholding tax varies depending on a range of factors, including the type of funding, the country of the non-resident and the relationship between the non-resident and the domestic recipient of the funding.</p> <p>Withholding taxes generally increase the required rate of return for foreign investors, which reduces the relative attractiveness of Australia as an investment destination. Where foreign investors can pass on the cost to domestic recipients of funds, this raises the cost of capital in Australia.</p> <p>For financial institutions, different funding mechanisms are subject to different rates of IWT. Reducing IWT (for the relevant funding mechanisms) would reduce funding distortions, provide a more diversified funding base and, more broadly, reduce impediments to cross-border capital flows.</p> <p>For foreign bank branches in Australia, interest paid on funds borrowed from the offshore parent is deductible, limited to the London Interbank Offered Rate (LIBOR) cap. This can prevent the branch from claiming the full interest cost of borrowing.</p> <p>Australia's IWT regime also applies to derivative transactions. Under G20 commitments, certain standardised over-the-counter derivatives need to be collateralised and cleared through a regulated central counterparty (CCP). In Australia, outbound interest payments on collateralised positions may be subject to IWT (flows from Australian participants to offshore CCPs, or flows from Australian CCPs to offshore participants). This may increase costs for Australian participants and adversely affect liquidity in Australian derivatives markets.</p> <p>Development of new financial markets that trade non–AUD denominated financial products (for example, RMB-denominated products) requires making markets across borders. Greater certainty regarding how withholding taxes are applied in these markets, and better alignment of the regime with regional trading partners, would aid market development.</p>
The Research and Development (R&D) Tax Incentive	<p>The R&D Tax Incentive provides businesses with annual tax offsets for eligible R&D costs.</p> <p>Submissions broadly support the regime, although some argue that more frequent access to tax offsets would help alleviate firms' cash flow constraints, particularly for new ventures.</p>
Tax treatment of Venture Capital Limited Partnerships (VCLPs)	<p>Simplifying the tax rules for VCLPs and streamlining Government administration of the regime would reduce barriers to fundraising. A 2011 Board of Taxation review (<i>Review of taxation arrangements under the Venture Capital Limited Partnership regime</i>) made recommendations to simplify the regime. In 2013, Government provided in-principle support for the recommendations.</p>

Issue

Tax treatment of funds management vehicles

In 2009, the Johnson Review (*Australia as a financial centre: Building on our strengths*) recommended changes to the tax treatment of funds management. Government has implemented some of the proposed changes but is still considering others, including expanding the range of collective investment vehicles (CIVs).

Typically, offshore investors require an investment vehicle that allows flow-through of any tax liabilities from the vehicle to the end investor. However, Australian tax law does not allow for the types of vehicles that both provide for flow-through and are familiar to offshore clients (particularly in Asia). A broader set of appropriate vehicles would better facilitate the management of foreign funds. The Board of Taxation reviewed tax arrangements applying to CIVs in 2011. Government is yet to release the report.

Tax treatment of superannuation: Tax concessions

Tax concessions in the superannuation system are not well targeted to achieve provision of retirement incomes. This increases the cost of the superannuation system to taxpayers and increases inefficiencies arising from higher taxation elsewhere in the economy, and the distortions arising from the differences in the tax treatment of savings. It also contributes to the broader problem of policy instability, which imposes unnecessary costs on superannuation funds and their members and undermines long-term confidence in the system (see *Chapter 2: Superannuation and retirement incomes*).

Tax treatment of superannuation: Differentiated tax rates on earnings

Earnings are taxed at 15 per cent in the accumulation phase, but are untaxed in the retirement phase. This can act as a barrier to funds offering 'whole-of-life' superannuation products and increases costs in the superannuation system.

Aligning the earnings tax rate between accumulation and retirement would reduce costs for funds, help to foster innovation in whole-of-life superannuation products, facilitate a seamless transition to retirement and reduce opportunities for tax arbitrage (see *Chapter 2: Superannuation and retirement incomes*).

Tax treatment of legacy products

Legacy products are financial products that are outdated and closed. These include some life insurance policies and interests in managed investment schemes.

Legacy products are a drag on the efficiency of product providers, which ultimately may lead to higher costs for consumers. In 2009, Government proposed a framework for rationalising legacy products; however, this has not yet led to an implemented solution. One significant issue is the tax treatment of underlying assets when legacy products are converted or consolidated into products with equivalent features or benefits (see *Recommendation 43: Legacy products* in *Appendix 1: Significant matters*).

Duties on insurance

Insurance taxes are levied by the states and territories. All states impose stamp duties on general insurance premiums, while some states impose additional levies—for example, fire service levies.

Insurance taxes mean that individuals and businesses must pay more to achieve the same risk reduction. Reducing duties on insurance would assist in dealing with underinsurance.

Tax treatment of non-operating holding companies (NOHCs)

With regard to corporate groups that include regulated entities, a group headed by a NOHC may give legal and operational separation to the group's regulated and non-regulated activities. In Australia, few financial groups are headed by NOHCs, and none of the four major banks operate under this structure.

A NOHC structure may provide financial institutions with greater flexibility in their activities. For regulators, a NOHC structure may facilitate supervision and resolution. However, restructuring carries significant costs for corporate groups, including tax implications. Making a move to a NOHC structure tax neutral would reduce disincentives to adopt this corporate structure.

Issue

Goods and services tax (GST)

GST is not levied on most financial services. This may contribute to the financial system being larger than it otherwise would 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.

As a result, households could be over-consuming financial services compared to what they would consume 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. This could result in businesses consuming fewer financial services than otherwise would be the case.

Appendix 3: Small and medium-sized enterprises (SMEs)

A number of the Inquiry's recommendations are designed to reduce structural impediments to SMEs' access to finance. Such impediments include information imbalances between lenders and borrowers, and barriers to market-based funding. Other recommendations would help reduce costs for SMEs and support innovation.

The Inquiry encourages industry to expand data sharing under the new voluntary **comprehensive credit reporting** (CCR) regime (see *Recommendation 20: Comprehensive credit reporting* in the *Chapter 3: Innovation*). More comprehensive credit reporting would reduce information imbalances between lenders and borrowers, facilitate competition between lenders, and improve credit conditions for SMEs. Although CCR relates to individuals' data, personal credit history is a major factor in credit providers' decisions to lend to new business ventures and small firms.

The Inquiry supports a facilitative regulatory regime for **crowdfunding**, while recognising the risks involved (see *Recommendation 18: Crowdfunding* in Chapter 3). A well-developed crowdfunding sector would give SMEs more funding options and increase competition in SME financing. The Inquiry supports Government's current process to graduate fundraising regulation to facilitate securities-based crowdfunding. Government should use these policy settings as a basis to assess whether broader fundraising and lending regulation could be graduated to facilitate other forms of crowdfunding, including peer-to-peer lending.

Information imbalances, among other factors, have led to numerous and onerous **non-monetary terms** in some lending contracts. The Inquiry supports Government's current process for extending consumer protections for unfair terms in standard contracts to small businesses (see *Recommendation 34: Unfair contract term provisions* in *Appendix 1: Significant matters*). Although such protections would not prevent unfair terms in non-standard contracts, the Inquiry believes this approach may improve broader contracting practices. The Inquiry also encourages the banking industry to adjust its codes of practice, to require banks to give borrowers sufficient notice of an intention to enforce contract terms and give borrowers time to source alternative financing.

Recommendations to reform the **payments system** would benefit SMEs (see *Recommendation 17: Interchange fees and customer surcharging* and *Recommendation 16: Clearer graduated payments regulation* in Chapter 3). The Inquiry's proposals to lower interchange fee caps would reduce the fees paid by all businesses and reduce the difference in fees paid by small and large businesses.

Financial System Inquiry — Final report

As technology evolves, **greater access to data and innovations in data use** are likely to benefit all businesses, particularly SMEs. For example, more extensive access to quality datasets would improve business decision making. Globally, payment providers are developing new ways to assess SMEs' creditworthiness and extend credit to SMEs. The Inquiry recommends that the Productivity Commission review how data could be used more effectively, taking into account privacy considerations (see *Recommendation 19: Data access and use* in Chapter 3).

The Inquiry considers that financial system innovators which challenge the existing regulatory structure should have better access to Government, and that Government and regulators should have greater awareness and understanding of financial system innovation. This would enable timely and coordinated policy and regulatory responses to innovation. The Inquiry recommends that Government establish a permanent public-private sector collaborative committee, the '**Innovation Collaboration**', consisting of senior industry, Government, regulatory, academic and consumer representatives (see *Recommendation 14: Collaboration to enable innovation* in Chapter 3).

Better targeted **tax settings** for start-ups and innovative firms would facilitate innovation. Simplifying the tax rules for Venture Capital Limited Partnerships, and streamlining Government administration of the regime, would reduce barriers to fundraising. More flexible access to research and development tax offsets could help reduce firms' cash flow constraints, particularly for new ventures. These issues should be considered as part of the Tax White Paper process (see *Appendix 2: Tax summary*).

Appendix 4: Consultation

Approach to the Inquiry

The Inquiry has taken a consultative approach to its task.

The Committee invited public submissions by 31 March, based on the terms of reference. The Inquiry received more than 280 submissions as part of this process.

The Inquiry invited a second round of submissions in response to the Interim Report, released on 15 July 2014, which made 28 observations and posed a series of questions seeking further information from stakeholders. The Inquiry received more than 6,500 submissions as part of this process.

In addition to formal submissions, Committee members have held bilateral meetings, roundtables and public forums in Australia over the course of the Inquiry. The Committee also met with the International Panel and undertook two international trips to meet with international regulators and financial intermediaries.

Consultation

Committee and Panel meetings

No.	Event	City
31	Financial System Inquiry Committee meetings	Sydney (1 meeting held in Canberra)
1	International Advisory Panel meeting (with Committee)	Sydney
2	International Advisory Panel meeting (with Committee)	Teleconference
1	International Advisory Panel meeting (with Committee)	Hong Kong

Public Forums

Location	Date	Committee Members attending
Perth	13 August 2014	David Murray, Craig Dunn
Melbourne	14 August 2014	David Murray, Kevin Davis, Brian McNamee
Brisbane	19 August 2014	David Murray, Carolyn Hewson, Brian McNamee
Sydney	20 August 2014	David Murray, Carolyn Hewson, Craig Dunn

Financial System Inquiry — Final Report

Roundtables

Location	Date	Event
Melbourne	9 May 2014	Industry Roundtable – Small Business
Sydney	16 July 2014	Post-Interim Report sector de-brief — Payments sector
Sydney	16 July 2014	Post-Interim Report sector de-brief — Financial Markets sector
Sydney	16 July 2014	Post-Interim Report sector de-brief — Banking sector
Sydney	17 July 2014	Post-Interim Report sector de-brief — General Insurance sector
Sydney	17 July 2014	Post-Interim Report sector de-brief — Superannuation and Life Insurance sector
Sydney	7 May 2014	Academic roundtable — Centre for International Financial Regulation
Melbourne	6 August 2014	Academic roundtable — Australian Centre for Financial Studies
Sydney	15 August 2014	Industry roundtable – Consumer outcomes
Sydney	18 August 2014	Post-Interim Report sector de-brief – Consumer organisations
Sydney	18 August 2014	Industry Roundtable – Small Business
Sydney	19 August 2014	Industry roundtable — Banking
Sydney	19 August 2014	Industry roundtable — Superannuation
Sydney	19 August 2014	Industry roundtable — Retirement Incomes
Sydney	21 August 2014	Academic roundtable — Centre for International Financial Regulation

Speeches

14 February 2014
Conduct of the Financial System Inquiry
Address to the Economic and Political Overview Conference, Sydney, Committee for Economic Development of Australia
David Murray AO, Chair, Financial System Inquiry

1 May 2014
Financial System Inquiry: An Update on Progress
Address to the Australian Business Economists, Sydney
David Murray AO, Chair, Financial System Inquiry

15 July 2014
Sustaining Confidence in the Australian Financial System — Launch of the Interim Report
Address to the National Press Club, Canberra
David Murray AO, Chair, Financial System Inquiry

Note: These speeches are available on the Financial System Inquiry website (see <http://fsi.gov.au>).

Stakeholder meetings

The Inquiry also participated in several hundred meetings with stakeholders. The table below summarises the stakeholder meetings attended by Committee members. It does not include the numerous stakeholder meetings conducted by the Secretariat.

Meetings in Australia

Pre-Interim Report		Post-Interim Report	
No.	Stakeholder category	No.	Stakeholder category
11	Government	13	Government
20	Financial Institutions	34	Financial Institutions
6	Consultants	1	Consultant
5	International	5	International
1	Service provider	2	Service providers
21	Peak bodies	16	Peak bodies
-	-	1	Individual (small business owner)
64	Total	72	Total

International Trips

Date	No. of meetings	Location
26 March 2014	5 meetings	Hong Kong
20–24 July 2014	17 meetings	Europe — Frankfurt ,Basel, London
24–30 July 2014	14 meetings	United States — New York, Washington DC
7–11 September 2014	10 meetings	Asia — Singapore, Beijing, Hong Kong

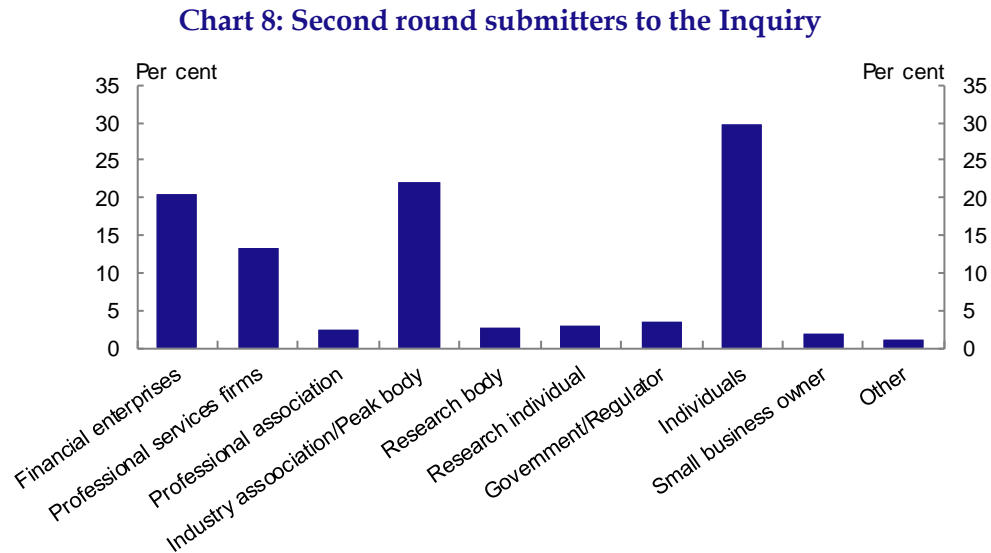
Submissions to the Inquiry

First round submissions (lodged up until 2 May 2014) are available on the Financial System Inquiry website (www.fsi.gov.au), except where authors requested confidentiality. A list of people and organisations that made non- confidential submissions is available at Appendix 3 of the *Financial System Inquiry Interim Report*.

The second round of submissions closed on 26 August 2014. Of the more than 6,500 submissions the Inquiry received in response to the issues set out in the Interim Report, more than 5,000 campaign submissions were received on the issue of ‘credit card surcharges’ — these are not listed below. Second round submissions are also available on the Inquiry’s website.

Analysis of submissions

Chart 8: *Second round submitters to the Inquiry* shows the composition of parties that made second round submissions to the Inquiry.

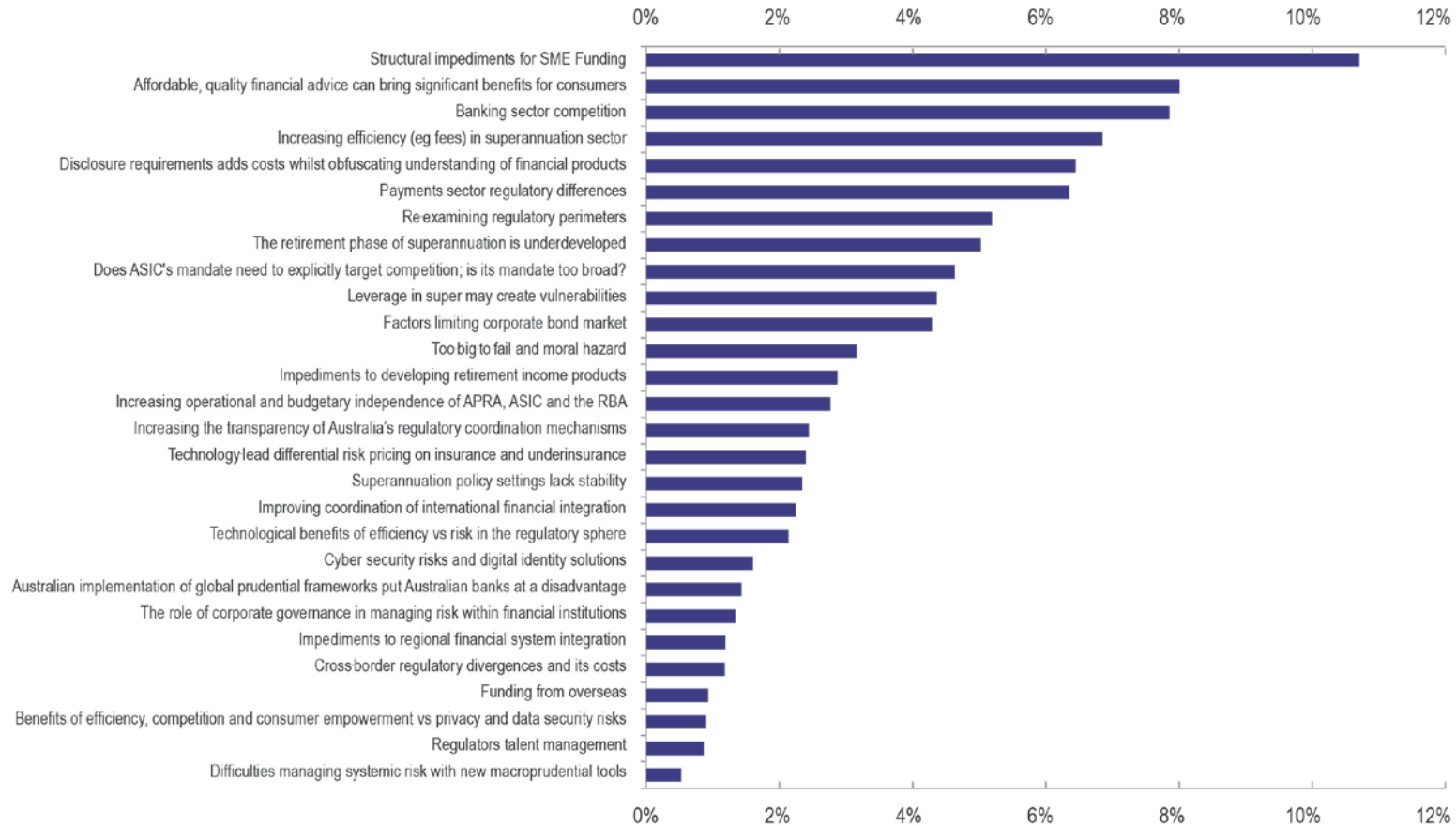


Source: Centre for International Financial Regulation. Excludes campaigns such as credit card surcharges and too-big-to-fail. Also excludes appendices, attachments, supplementary materials and confidential submissions.

Chart 9 (page 289) shows the frequency that Interim Report observations were raised in second round submissions.

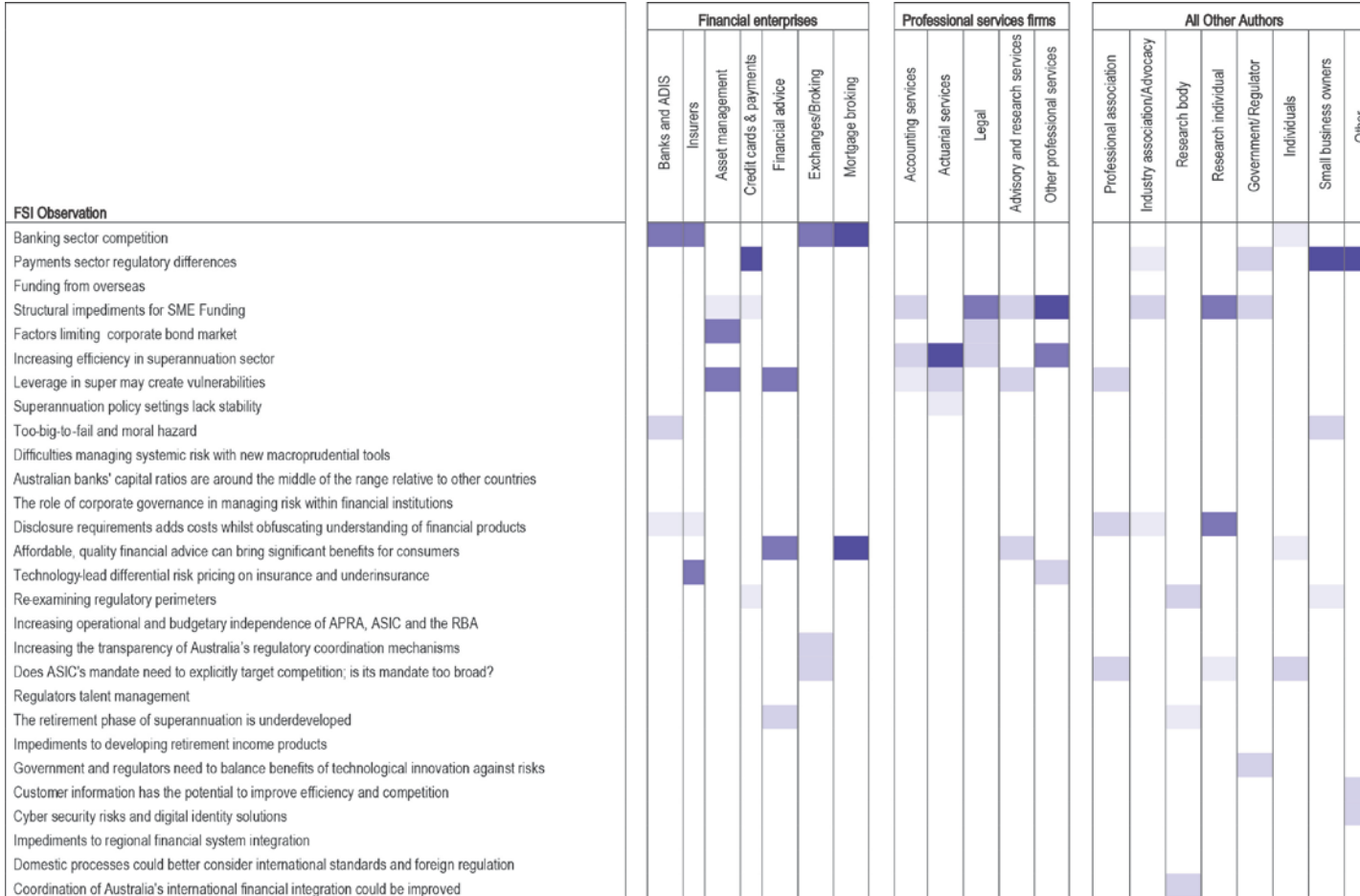
Chart 10 (page 290) shows the three observations that each category of stakeholder raised most frequently in the second round of submissions. The darker shade represents a heavier focus on that observation.

Chart 9: Frequency that Interim Report observations were raised in second round submissions



Source: Centre for International Financial Regulation and Centre for Law, Markets and Regulation. Excludes campaigns such as credit card surcharges and too-big-to-fail. Also excludes confidential appendices, attachments, supplementary materials confidential submissions.

Chart 10: Top 3 observations in second round submissions from each category of stakeholder



List of submitters

The following people and organisations made non-confidential second round submissions. The Interim Report lists the people and organisations that made non-confidential first round submissions.

ACTU	AMP	Atkinson, Graham
Aarsten, Xavier	Anderson, R	Atkinson, Pamela
Aceti	Anfruns, Michael	Atkinson, Thomas
Actuaries Institute	ANZ	Attiwill, Ian
Adams, G	ANZ and the Consumer Action Law Centre	Aussie
Adams, Helen		AUSTRAC
Adams, Nora	Apps, Terry	Australian APEC Study Centre
Adams, Thomas	Apswoude, David	Australian Bankers' Association (ABA)
Adams, W	Arnhem Investment Management	Australian Business Register (ABR)
Adkins, John	Arnold, James	Australian Centre for Financial Studies (ACFS)
Aebi, Bruno	Ashby, Damien	
Ainslie, Frank	Ashby, Leon	
Aldridge, Les	Asia Pacific Stock Exchange Limited	Australian Council of Social Service (ACOSS)
Alfonso, Alfredo	Association of Financial Advisers (AFA)	Australian Council of Superannuation Investors (ACSI)
Alford, M & J	Association of Superannuation Funds Australia (ASFA)	Australian Digital Currency Commerce Association
Allianz		
Allison, Anthony	ASX Ltd	Australian Finance Group
American Express	Atchison Consultants	

Financial System Inquiry — Final Report

Australian Financial Markets Association	Australian Retailers' Association	Banking and Finance Consumer Support Association
Australian Financial Security Authority (AFSA)	Australian Securities and Investments Commission (ASIC)	Bankmecu
Australian Foundation Investment Company	Australian Securitisation Forum	Bardon, Richard
Australian Industry Group	Australian Shareholders Association	Barlow, Rita
Australian Institute of Company Directors	Australian Super	Barry, Annie
Australian Institute of Superannuation Trustees (AIST)	Ayling, Michael	Barry, Ernie
Australian Listed Investment Companies Association	Back, Deborah	Barry, Michael
Australian Newsagents' Federation Ltd	Badcock, Paul	Bartlett, Donald
Australian Payments Clearing Association (APCA)	Baddeley, Margaret	Bartlett, Gerald
Australian Private Equity & Venture Capital Association	Bain, John	Barton Consultancy
Australian Prudential Regulation Authority (APRA)	Baines, Ron	Bartosch, Klaus
Australian Restructuring Insolvency & Turnaround Association (ARITA)	Baker & McKenzie	Bartron, Clive
	Baker, Bruce	Barwick, Elisa
	Baker, Caroline	Bateman, Alan & Claire
	Baker, Lynn	Bauer, David
	Baker, Ross	Baum, RL
	Ballistic Eng	Beaton, Ashley
	Bamfield, Michael	Beck, Cameron
	Bank Doctor, The	Beck, Jeremy
	Bank Reform Now	Beecroft, Theresa
	Banki Haddock Fiora	Bell, Peter
		Belmont Business Enterprise Centre

Appendix 4: Consultation

Belonogff, Michael	Boyd, Alisa	Bruce Mulvaney & Co
Bernal, Ivo	Boyd, Keith	Buckland, Dianne & Ray
Best, Kris	BPAY	Buckley, Ross and Ooi, Ken
Biddulph, Noel	Bradford, Don	Bunning, Scott
Bingley, Rhys	Bradford, Kael	Burgess, Steven
Bird, Steve	Brandson, Peter	Burke, AJ
Blacktown City Council	Breckenridge, Alistair	Burnett, Geoffrey
Blake, Jason	Breustedt, Francis	Burro, Guido
Blake, Stephen	Breward, Alun	Business Council of Australia
Blasen, Christian	Britten, Jamie	Bussenscheet, Val
Block, Milton	Britten, RJ	Busuttil, Paul
Boardman, Warwick	Broadbent, Betty	Butler, Greg
Bodey, James	Broadbent, Henry	Butler, Robert
Bone, David	Broadbent, Keith	Button, Jennifer
Bonham, James	Broadridge Financial Solutions	Byrne, Richard
Booby, Maxine	Broff, Roy	Caiani & Company
Booth, Don	Brooks, Jason	Campbell, A
Bourke, Bernie	Brotherhood of St Laurence	Campbell, Bruce
Bourne, Duncan	Brown, Gregory	Campbell, John
Bourne, Glenyss	Brown, Neville	Campbell, Sandy
Boutique Financial Planners	Brown, Peter	Campbell, Trudy
Bower, D	Brown, Robert	Campbell, W
Boxall, Malcolm	Brownlie, Peter	

Financial System Inquiry — Final Report

Cantarella, John	Chamber of Commerce and Industry Queensland	Clanchy, Michael
Capone, Malcolm		Clarity Advisory and Training Solutions Pty Ltd
Carnegie, Les	Chan & Naylor	
Carnellor, Amanda	Chant West	Clark, Allan
Carter, John	Chapman, Graeme	Clark, Ian
Carters	Chapman, Janet and David	Clark, Judith
Cash, Brett	Chapman, Peter	Clarke, Elizabeth
Cash, Clinton		Clarke, Frank
Cash, Glennis	Chartered Accountants Australia and New Zealand	Clarke, Terry
Cash, Nathan		Clayton Utz
Catrevena	Chatzitaskas, Nick	Clifford, Richard
Cavendish Superannuation	Cheever, Paul	Clyde, Barry
	Chegwyn, John	Coburn, Niall
Centre for Commercial and Property Law – Queensland University of Technology	Chessell, Leo	Coles
	Chin, Debbie	Collingwood, Bevan
Centre for Digital Business	Chi-X Australia Pty Ltd	Combined Pensioners and Superannuants Association of NSW Inc (CPSA)
	Chizhov, Mikhail	
Centre for International Finance and Regulation (CIFR)	Chizhova, Tatyana	Comiskey, D
	CHOICE	
Centre of Excellence in Population Ageing Research (CEPAR)	Christensen, Kay	Commercial Asset Finance Brokers Association of Australia (CAFBA)
	Chung, Lisa	
CFA Societies Australia	Citizen Freeman Pty Ltd	Commins, Darren
Challenger		Committee for Sydney
	Citizens Electoral Council	Commonwealth Bank

Appendix 4: Consultation

Concannon, Edward	Council of Social Service of NSW (NCOSS)	CV Solutions
Connors, Robert	Cousins, Paul	Czajka, Micahel
Connors, Ron	Cowling, Nan	Dagger, William
Consumer Action Law Centre	CPA Australia	Dahlsen, John
Convenience and Mixed Business Association (CAMBA)	Crerar, Amanda	Dale, Bernard
Cooke, Heather	Cross, Phillip	Dalug, John
Cooke, Lynda	Crossing, Margot	Daly, Gary
Cooper, J	Crowder, Colleen	Daniels, Ian
Copas, Murray	Crowe, Mary	Davey, Danielle
Corbin, Michael	Crowther, Charles	Davey, Shaun
Corin Jacka Financial Solutions	Crowther, Sonya	Davies, Matthew
Cornell, Geoff	CSA Limited	Davies, Rodney
Corporate Superannuation Association	CUA	Davis, Lindsay
Cosgrove, Lindsay	Cullen, Jill	Davis, Peter
COTA	Cullen, Patrick	Davis, Stephen
Cotter, Patrick	Cullen, WB	Davy, Jeffrey
Cotterell, Liliias	Culling, Nick	Daw, John
Cottrell, M	Culverwell, John	Dawborn, Anne
Coué, PL	Cummings, Trevor	de la Motte, Rolfe
Council of Small Business Australia (COSBOA)	Curtis, Bob	Dean, Geoffrey
	Customer Owned Banking Association (COBA)	Della Gatta, Norma
	Cuticone, Vince	Deloitte
		Deloli, Kent
		Denise, Michelle

Financial System Inquiry — Final Report

Desreaux, Barry	Eberle, R & D	EY
Detjen, Henry	Economic Reform Australia	Fadden, Vicki
Dewis, David	Edam, N	Faddoul, Charles
Dibbs Barker	Edmunds, Roy	Fallon, Frances
Dickson, Gillian	Edstein, John	Farraher, P
Dignam, Adrian	Edwards, Dale	Farrington, G
Dilley, Allen	Edwards, Josie	Feltham, Gregory
Dillon, Craig	Edwards, Peter	Fernandes, Pearl
Dimensional	Edwards, Thelma	Ferrall, David
Dixon Advisory	Edwards, Walter	Ferriday, D
Djerriwarrh Investments Limited	Eedy, Peter	Ferrier Hodgson
Doherty, William	eftpos	Ferrier, Peter
DomaCom	Eggins, Christine	Ferriggi, Francis
Donaldson, Bill	Eldridge, Janice	Ficken, John
Donaldson, David	Eley, Steven	Field, Allen
Dooley, Clint	Elliott, Elizabeth	Financial Institutions & Management Advisory (FIMA)
Downey, Tony	Ellis, Shane	Financial Ombudsman Service
Downham, M	Empirical Capital	Financial Planning Association of Australia Limited
Drake, Tony	Equip	Financial Rights Legal Centre
Dudley, Berice	Erikson, Peter	
Dunn, Gavin	Erskine, Alex	
Dziadosz, Lucas	Eva, Keith & Gail	
East, Deb	Evans, Stacie	Financial Services Council (FSC)

Appendix 4: Consultation

Financial Services Institute of Australasia	Game, Bill	Grant, David
Fisher, Julie	Gapes, Gordon	Gray, Allan
Fleet, Ray	Gaskell, Robin	Greening, Peter
Fleming, Donna	Gay, Norman	Grenfell, Colin
Fletcher, George	Geissman, Mark	Greville, Mark
flongle	Genworth	Group of 100
Flood, Francis	Geritz, Elise	Grubb, Mark
Flory, Paul	Geritz, Tony	Guley, Gordon
Forbes, Alistair	Gerrish, Robert	Gulf Elect
Forbes, Peter	Gibb, BJ	Hadfield, James
Force, Rod	Gillard, Amber	Hall, Simon
Foresters Community Finance	Ginidis, Peter	Hallam, K
Forrest, Frederick	Gleeson, Lynne	Halstead, Brian
Forrest, John	Goldsmith, Don	Hamblion, Robert
Forrest, Tim	Goldthorpe, Aileen	Hamilton, Christine
Forster, Russell	Good Shepherd Microfinance	Hamilton, G
Fosters, Rolf	Gordon, Andrew	Hamilton, Greg
Fox, Andrew	Gordon, Ian	Hand, Graham
Fraser, Roderick	Gors, Beryl	Hansman, AP
Fraser, the Right Honourable Malcolm	Gough, Michael	Harden, Stewart
Freedman, Ben	Goulter, Max	Harding, Stephen
Friendly Societies of Australia	Goumas, Costas	Harfouche, Gabriel
	Graham, the Honourable Peter QC	Harris, Andrew
		Harry, Paul

Financial System Inquiry — Final Report

Hart, Stuart	Herrmann, Teresa	Hornsby, Chris
Harvey, AE	Hetherington, Maurice	Houghton, James
Harvey, Helen	Heugh, John	Housing Industry Association (HIA)
Harvey, Mr & Mrs L	Heyward, Rick	Howard, Scott
Harvey, Steven	Hill, MW	Howarth, James
Haw, William	Hilton, Roger	Howell, Michael
Hazel, Gary	Hingston, Philip	Hu, Ling-chia and Lyons, Mark
Hazzard, James	Hirsch, Siegfried	Hubbard, Carole
Healy, Pat	Hoar, Peter	Hull, Brian
Heazlett, William	Hobbs, Beverley	Humar, Leopold
Hedditch, Robert	Hoffman, Peter	Hunneman, Jack
Hegglun, Ian	Hogan, Greg	Hunt, Howard
Henderson, Gail	Hogan, Margaret	Hunt, Warwick
Henderson, Michael	Holding, Rod	Hunter, Gordon
Heng, Adriel	Holiday Coast Credit Union	Hunter, Steven
Henke, Grant	Hollingworth, Annette	Hurley, Stan
Henson, Fiona	Holloway, Llewellyn	Hutchinson, Gerard
Henzell, Leonard & Gail	Homesafe Solutions	Hydrargyros Pty Ltd
Herbert Smith Freehills (ASIC Funding)	Homolka, Paul	Ibrahim, Ali
Herbert, Greg	Honeyman, Greg	Ifield, David
Herman, Paul	Hope, Daniel	Ifield, Kerrie
Herman, Rudolf	Hopkins, Raymond	Ifield, William
Hermann, Margaret	Horne, Colin	IFM Investors

Appendix 4: Consultation

Impact Investing Australia	Jackson, Anne	Kasupene, Morgan
Impact Investment Group	Jacobs, Richard and Jacqueline	Kavanagh, Bryan
Income is the Goal	James, Philip & Ewa	Kay, Jacqueline
Independent Fund Administrators & Advisers (IFAA)	Jamieson, John	Kealley, Dave
Industry Group, The	Jans, Ray	Kean, Michael
Infrastructure Australia	Jans, Sarah	Kearnan, R
ING Bank Australia	Jans, Sheryn	Keenan, Peter
Ingrey, William	Jelleff, John	Keizer, Dirk
Innovation Australia	Jenatsch, R	Kelly, Bernard
Insurance Australia Group (IAG)	Jeray, Eva	Kelly, Derek
Insurance Council of Australia	Johnson, Anthony	Kelly, Gilbert
International Swaps and Derivatives Association (ISDA)	Johnston, Brian	Kelmar, John
Isherwood, Aaron	Jones, Evan	Kemp, Raelene
Isherwood, Craig	Jones, Kaye	Kennedy, Rosanna
Isherwood, Glen	Jones, Leon	Kennelly, Peter
Isherwood, Katherine	Jordan, David	Kettlewell, Michael
Italiano, Pietro	Jordan, Tom	Kinderis, Stan & Stephanie
Ivanov, George	Jorgensen, Erik	King & Wood Mallesons
Izzett, Guy	Joyce, DE	King, Anthony
	Juhasz, Stephen	King, Roselyn
	K&L Gates	King, Steve
	Kanavas, Tania	Kingsford Smith, Dimity
	Karg, Frank	

Financial System Inquiry — Final Report

Kirov, Kris	Law Council of Australia (Business Law Section)	LM Investor Victim Centre (LMIVC)
Kitto, Ernest		Lock, Diane & Max
Klein, Stephen	Law Council of Australia (Superannuation Committee, Legal Practice Section)	LokalITy Pty Ltd
Klein, SW		Lovell, Dean
Kloas, Ewen		Lovett, Peter
Klose, Werner	Lawler, Krista	Lowe, Neville
Kobold, Alex	Lawler, Peter	Loyall, Ken
Kociemski, Chris	Laws, Daniel	Lyell, Charles
Koenders, Olaf	Lazarenko, M & Marcussen, D	Lynch, Troy
Koops, Jim	LCH.Clearnet	Lyons, Jill
KordaMentha	Legal Aid NSW	Macdonald, Diana
Kosmas, Jim	LeGarde-Glasko, Inez	Mace, Lincoln
KPMG	Leikov, Joreje	Mackenzie, Alan
Kucina, SJ	Lekakis, G, Rogers, I and Manning, P	MacPherson, Ron
Kylstra, Wytze	Lele, Stephen	Macquarie Group
Lacey, Nigel	Lemon, Robert	Macqueen, Angus
Lahy, Colleen	Lenane, A & P	Maddock, Rodney
Lahy, Michael	Lenoese, N	Madonald, Ian
Lane, Alan	Lepse, Traudi	Madsen, John
Lange, Jonathan	Lewis, Kevin	Maher, Mike
Lanzi, D	Liebmann, George	Mair, Peter
Larsen, Ben	Lipman, Julian	Malfiore, S & G & L
Latimer, Paul		Manadavadi, Pravin
Lavery, Dorothy		

Appendix 4: Consultation

Manestar, Ivan	McCallum, Graham	Mercer
Marks, Danny	McCarthy, Jonathan	Mesch, Monica
Marks, David	McCormick, Rob & Lesley	Meyers, Peter
Maroun, Paul	McCosker, Richard	Meyers, Rod
Martin, Colin	McCullagh, James	Micah, Jim
Martin, Gordon	McDermott, Chris	Michaelisks, Con
Martin, John	McDonald, Chris	Microsoft
Martin, Ken	McDonald, Danielle	Migga, Jenyce
Marx, Tony	McEwan, Marcus	Milborrow, John
Master Builders Australia	McFee, Claire	Minter Ellison
Master Grocers' Australia	McGing Advisory & Actuarial	Minter, Steven
MasterCard	McGrathNicol	Mistry, Cyrus
Mate, Joseph	McKay, Ralph	Mitchell, Doug
Mathews, Rose	McKinnon, Lorne	Mitchell, Tara
Matoga, L	McNally, Kerry	Modra, John
Matoga, W	McNally, Noel	Moffat, Gordon
Maurice Blackburn Lawyers	McNamara, Glen	Moir, Margaret
Maxwell, Robert	McNess, John	Mollison, Charles
Mayman, Wendy	McPherson, M	Money Farms
McAuley, JP	McQueen, Colin	Monkey Mia Wildsights
McAvoy, John	ME Bank	Moran, Janice
McCahon, Dale	Medibank	Morehead, Basil
	Meggitt, Cathleen	Moreton, Barry

Financial System Inquiry — Final Report

Morgij Analytics	Investments Inc (NICRI)	Noonan, Jim
Mori, Don		Norton, Tom
Morningstar	National Insurance Brokers Association of Australia	NSW Small Business Commissioner
Mortgage and Finance Association of Australia (MFAA)	National Seniors Australia	O'Connor, Akiko
Motive Power	Neal, Sandra	O'Niell, Kevin
Mowe, Jeremy	Neave, Barbara	Oakes, Rick
Moxham, Brian	New Zealand Council of Financial Regulators	Oakes, Robert
Muir, Barry		O'Brien, Benjamin
Muldoon, MH	Newcombe, Ray	O'Brien, John
Muller, R	Newling, Valerie	O'Brien, Justin and Gilligan, George
Murphy, Philip	Newnham, Gary	O'Brien, Timothy
Murrell, Anthony	Nguyen, Khoa	Ockerby, James
Musumweci, Cecily	Nichols, Adam	O'Connell, R
Myers, Peter	Nichols, Bevlee	Office of the Australian Information Commissioner
NAB	Nichols, Damon	
Name Withheld 1	Nichols, Inez	Ogden, Dereka
Name Withheld 2	Nichols, Keverne	O'Keefe, Dan
Name Withheld 3	Nichols, Lauren	Olimpio, Domenic
Name Withheld 4	Nichols, Lorna	Olman, Lindsay
Name withheld 5	Nichols, S	O'Shea, Andrew
Narrow Road Capital	Nilov, Alexei	Ottrey, Philip
National Information Centre on Retirement	Nilov, Marina	Owen, Greg
	Nolan, Pauline	Ozich, Jim

Appendix 4: Consultation

P&N Bank	Phair, Richard & Margaret	Property Council of Australia
Papadimitriou, Stan	Phelps, John	Property Funds Association
Papazoglov, Dimitrios	Philanthropy Australia	Provic Group Inc
Paradis Family Group, The	Phillips, Rhandall	Providence Wealth Advisory Group
Parkes, Brian	Phillips, WJ	Pukallus, Dennis
Parry, Alan	Piesse, John	Pukallus, Jan
PayPal	Pilkington, Merridee	Purvis, Russell
Pearce, Benjamin	Pitabh, Roland	QBE
Pearce, Matthew	PlayfairTan	QIC Limited
Pearson, Faye	Plumecocq, Michael	QSuper
Pelekani, Con	Poett, Jenny	Quicke, Allan
Peltpnen, Tuija	Pohl, Nerida	Quilter, Lorna
Penberthy, Paul	Polymath Investors Proprietary Limited	R, Ronald
Pensions Institute (London)	Portelli, Steven	Radford, Edwin
Pepper, Chris	Portelli, William	Rainmaker Information
Perrot, Chris	Potter, David	Ralfs, Keith
Perry, John	Potticary, J	Ray, John
Peters, Greg	Power, Colin	Rayner, Frank
Peterson, Monique	Praporski, Alex	Rea, Pauline
Petterson, David	Presnell, Adam	Read, Arnold
Pettett, Geoff	Preston, Laurie	Real Estate Institute of Australia
PEXA	Priestly, Claire	Real, Roger
Pfeiffer, Neville	Pronczak, Peter	

Financial System Inquiry — Final Report

Reed, Andrew	Rourke, Philip	Schmidt, Kunobert
Regional Banks (on behalf of BoQ, Bendigo and Adelaide Bank, ME Bank and Suncorp Bank)	Rowe, Peter	Schmulow, Andy
Regional Policy Advisory Committee	Rowlands, Ronald	Schorel-Hlavka, GH
Research Australia	Rowles, Kerry	Schreurs, Martin
Reserve Bank of Australia (RBA)	Roysland, Peter	Schroder Investment Management Australia Limited
REST Industry Super	Rubina, Carlos	Schutz, Maurice
Reti, Daniel	Rumble, Dr Tony	Scroop, Eric
Rhines, Eleanor	Rumble, Lee	Searton, R & A
Rice Warner	Runcie, Neil	See, Alexandra
Rickard, Neil	Russo, Mario	Seed, Jeff
Rider, Alan	Rutherford, James	Seriya, Mel
Ritchies Stores	Ruyg, Michael	Seymour, Michael
Roan, Bruce & Lorna	Ryan, Gerard	Shaw, R
Roberts, Ben	Sage, Graham	Shields, Geoff
Robinson, Jean	Sallwan, Garette	Shields, Simon
Robinson, Wayne	Salt, Philip	Shire of Beverley
Rodgers, John	Sambastian, Pierre	Shus, Ed
Rogan, William	Scallan, Bronwyn	Siddall, Clytie
Rolfe, Brendan	Scalzi, Robert	Siebert, Lisa
Rollond, Ken	Scarfone, Frank	Siebert, Paul
Roubicek, Roger	Schiemer, Donald	Simkiss, John
	Schippl, Helmut	Simpson, Campbell
	Schlusser, William	Sims, Daniel
	Schmetzer, Errol	

Appendix 4: Consultation

Sincock, Philip	Soos, Richard	Strahan, Colin
Sjogren, Karl	Soulos, Andrew	Strategies Plus
Slattery, Pat	Spain, David	Stratford, Narelle
Sledge, RA	Spajic, Paul	Stratford, Noel
Small, Garrick	Spijer, Daan	Strathfield Council
Smith, Derek	Spinks, June	Street, Peter
Smith, G	Spyker, Len	Sturgiss, Denzil
Smith, Luke	St George Community Housing Limited (SGCH)	Styles, Carol
Smith, Mark		Styles, Wayne
Smith, P	Staehr, Jeanette	Sudholz, Judith
Smith, Ray	Stallard, Geoff	Sullivan, Kerry
Smith, Rick	Standard & Poor's	Suncorp Bank
Smith, Rod	Stanton, Heather	Suncorp General Insurance
Smith, Russell	Steel, Stephen	Suncorp Life
Smith, Sharon	Stevens, Renae	Super Innovations
Smith, Sidney	Stevenson, Derek	Superannuation Consumers Centre
SMSF Owners' Alliance (SMSFOA)	Stevenson, Richard	SuperEd
SMSF Professionals Association of Australia (SPAA)	Stockbrokers Association of Australia	SuperGuardian/Xpress Super
Smyth, John	Stone, RG	SuperRatings
Social Enterprise Finance Australia Ltd (SEFA)	Storey, Dianne	Supported Residents & Carers Action Group
Solaiman, Sheikh	Storm, PA	Swan, Graham
	Stott, Chris	
	Stow, David	Swiggs, David

Financial System Inquiry — Final Report

Sy, Wilson	Tonkin, Tommy	van Schaik, Heidi
Syme, Graham	Townsend, Kendall	Vasanji, Suzann
Synchron	Townsend, Norm	Veda
TAL Dai-chi Life Australia Pty Limited	Treagar, Robert	Veit, Christian
Tannberg, Carsen	Trent, Kevin	Venkatramani, Ramani
Tasmanian Small Business Council	Triple W Farms Pty Ltd	VentureCrowd
Tate, Sue	Trouncer, Jody	Verheyen, Gerry
Taxpayers Party, The	Tucci, Michael	Veronika
Telford, John	Tuffnell, Ian	Victorian Teachers Mutual Bank
Tesconi, Ernie	Turnaround Management Association of Australia Ltd	Vincent, Neill
Tew, Danny	Turner, Les	VISA
Thies, Dick	Turner, Mark	Vogel, Luke
Thomas, Brian	Turvey, Claire	Wall, Terry
Thomas, Peter & Margaret	Turvey, R	Walsh, Alexander
Thompson, Bruce	Turvey, Wener	Walsh, Paul
Thompson, Martin	Twelftree, Matthew	Walters, Eric
Thornton Tucker	Tyas, Brian	Wansbrough, Gary
Thornton, Margaret	Tyro Payments	Warriner, William
Thurlow, Kimball	UniSuper Management Pty Ltd	Watkins, Richard
Thystrup, Lars	Utber, Dororhy	Watson, Barry
Tkacz, Henrik	van Roosendael, Edmund	Watson, John
Tom Lawler Transport		Weigang, Michael
		Welch, AJ

Appendix 4: Consultation

Wells, Kath	Williams, Barry	Yohanna, Sleiman
Wells, NW	Williams, Benjamin	Yong, Leonard
West, Matthew	Williams, Cholm	YPINH National Alliance
Westley, Mark	Williams, Gillian	Zell, Max
Westpac	Williams, Kevin	Zimmermann, Michaela
Weymouth, John	Williams, Michael	Zumbo, Vincenzo
Wheeler, Bill	Williams, Paul	
White Label Personal Clouds	Williams, Ray	
White, Colin	Willsher, Trevor	
White, Mary	Wilson Asset Management	
White, Patricia	Wilson, Gilbert	
White, Robert	Wiltshire, Diana	
Whitehead, Bruce	Winniak, Daniel	
Whitehead, Gareth	Witten, Richard	
Whitehead, Shae	Wizard, Paul	
Whitelaw, Wilma	Wizner, Ross	
Whitney, Ani	Woldt, Lee	
Whythom, Ben	Wood, Don & Anita	
Wilde, Milton (Submission 1)	Wood, Ian	
Wildwood, Wolf	Wrae, Louisa	
Wilkie, Ken	Wraith, Pauline & Barry	
Wilkinson, Mark	Yabsley, Bob	
Williams, Alfred	Yaretsky, Ian	

Appendix 5: Glossary, acronyms and abbreviations

Acronyms and abbreviations

ABA – Australian Bankers' Association

ABN – Australian Business Number

ABP – account-based pension

ACCC – Australian Competition and Consumer Commission

ACSC – Australian Cyber Security Centre

ACTU – Australian Council of Trade Unions

ADI – authorised deposit-taking institution

AFA – Association of Financial Advisers

AFMA – Australian Financial Markets Association

AFSA – Association of Superannuation Funds of Australia

AFSL – Australian Financial Services Licence

AFTS – Australia's Future Taxation System

AGD – Attorney-General's Department

AGIMO – Australian Government Information Management Office

AIST – Australian Institute of Superannuation Trustees

AML – anti-money laundering

ANAO – Australian National Audit Office

Financial System Inquiry — Final report

APCA – Australian Payments Clearing Association Limited

APRA – Australian Prudential Regulation Authority

ARCA – Australian Retail Credit Association

ASC – Australian Securities Commission

ASIC – Australian Securities and Investments Commission

ASFA – Association of Superannuation Funds of Australia

ASSOB – Australian Small Scale Offerings Board

ASX – ASX Limited or the exchange operated by ASX Limited

AT1 – Additional Tier 1

ATM – automated teller machine

ATO – Australian Taxation Office

AUSTRAC – Australian Transaction Reports and Analysis Centre

AVCAL – Australian Private Equity and Venture Capital Association Limited

BCBS – Basel Committee on Banking Supervision

BIS – Bank for International Settlements

bps – basis points

CAMAC – Corporations and Markets Advisory Committee

CCP – central counterparty

CCR – comprehensive credit reporting

CEO – Chief Executive Officer

CET1 – Common Equity Tier 1

CDFI – community development financial institution

Appendix 5: Glossary, acronyms and abbreviations

- CDI** – CHES depositary interest
- CFR** – Council of Financial Regulators
- CIPR** – comprehensive income product for retirement
- CSEF** – crowd-sourced equity funding
- CSS** – Cyber Security Strategy
- CTF** – counter-terrorism financing
- D-SIB** – domestic systemically important banks
- DC** – defined contribution
- DHS** – Department of Human Services
- DLA** – deferred lifetime annuity
- DVS** – document verification service
- EFT** – electronic funds transfer
- ESMA** – European Securities and Markets Authority
- FATCA** – Foreign Account Tax Compliance Act (US based legislation)
- FCA** – UK Financial Conduct Authority
- FCA Act** – Financial Corporations Act 1974
- FCS** – Financial Claims Scheme
- FIDO** – Fast Identity Online alliance
- FINRA** – Financial Industry Regulatory Authority
- FIRB** – Foreign Investment Review Board
- FMI** – financial market infrastructure
- FOFA** – Future of Financial Advice law reform

Financial System Inquiry — Final report

FSAC – Financial Sector Advisory Council

FSAP – Financial Sector Assessment Program

FSB – Financial Stability Board, formerly the Financial Stability Forum.

FSG – Financial Services Guide

FWC – Fair Work Commission

G-SIB – global systemically important bank

G20 – Group of Twenty Finance Ministers and Central Bank Governors from 20 major economies

GDP – gross domestic product

GFC – global financial crisis

GSA – group self-annuitisation

GST – goods and services tax

HQLA – high-quality liquid assets

IADI – International Association of Deposit Insurers

IC – Innovation Collaboration

IMF – International Monetary Fund

IOSCO – International Organisation of Securities Commissions

IRB – internal ratings-based

IWT – interest withholding tax

KYC – know your client/customer

LEI – legal entity identifier

LEIROC – Legal Entity Identifier Regulatory Oversight Committee

Appendix 5: Glossary, acronyms and abbreviations

LIBOR – London Interbank Offered Rate

LRBA – limited recourse borrowing arrangement

MIS – managed investment scheme

NGO – non-government organisation

NOHC – non-operating holding company

NPV – net present value

OBPR – Office of Best Practice Regulation

OECD – Organisation for Economic Co-operation and Development

OIX – Open Identity Exchange

OSC – Ontario Securities Commission

OTC – over-the-counter trading

P2P – peer to peer

PAYE – Pay As You Earn

PAYG – Pay As You Go

PC – Productivity Commission

PDS – product disclosure statement

PJCCFS – Parliamentary Joint Committee on Corporations and Financial Services

PPF – purchased payment facility

PSB – Payments System Board

R&D – research and development

RBA – Reserve Bank of Australia

RCAP – Regulatory Consistency Assessment Programme

Financial System Inquiry — Final report

RIS – Regulation Impact Statement

RMB – Reminbi, the official currency of the People’s Republic of China

RMBS – residential mortgage-backed securities

ROE – return on equity

SG – superannuation guarantee

SIS Act – *Superannuation Industry (Supervision) Act 1993*

SIS Regulations – Superannuation Industry (Supervision) Regulations 1994

SME – small and medium-sized enterprises

SMSF – self-managed superannuation fund

SOA – Statement of Advice

SOE – Statement of Expectations

SOI – Statement of Intent

UCT – unfair contract term

UFI – Unauthorised Financial Insurer

VCLP – Venture Capital Limited Partnerships

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 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.

Australian Competition and Consumer Commission (ACCC) – a national 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.

Australia's Future Tax System (AFTS) – *Australia's future tax system, Report to the Treasurer*, December 2009, Australian Government, Canberra.

authorised deposit-taking institution (ADI) – an institution authorised by APRA to carry on banking business such as a bank, credit union or building society.

Financial System Inquiry — Final report

Basel I, II, III standards – the Basel Committee on Banking Supervision standards governing internationally active banks.

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.

Bitcoin – a type of digital currency.

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 that participate in BPAY, using account transfers initiated by phone or internet. The transfers may be from savings, cheque or credit card accounts.

basis points (bps) – a basis point is 1/100th of 1 per cent or 0.01 per cent. The term is used in money and securities markets to define differences in interest or yield.

borrower – a person or entity that incurs a debt to a lender on agreed terms.

capital market – a market for medium to long-term financial instruments. Financial instruments traded in the capital market include shares, and bonds issued by the Australian Government, State governments, corporate borrowers and financial institutions.

CHESSE depositary interest (CDI) – a financial product that is a unit of beneficial ownership in an underlying financial product quoted on the ASX.

Common Equity Tier 1 (CET1) capital – comprises ‘tangible’ equity such as shareholders’ common equity.

Comprehensive Credit Reporting (CCR) – a change in credit reporting legislation introduced in March 2014. The change will mean lenders must report positive information about how well consumers meet their repayments, not just negative events, such as defaults.

Comprehensive product for retirement (CIPR) – a combination of products that is designed for retirement that, at a minimum, provides individuals with income, flexibility and risk management (particularly for longevity risk).

Consumers – ‘retail clients’ as defined in the *Corporations Act 2001*.

Appendix 5: Glossary, acronyms and abbreviations

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.

Cyber Security Strategy (CSS) – Australian Government’s 2009 Cyber Security Strategy.

deferred lifetime annuity (DLA) – a form of lifetime annuity for which income payments are delayed for a set amount of time.

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.

ePayments code – an update and replacement of the Electronic Funds Transfer Code of Conduct.

Financial Claims Scheme (FCS) – a guarantee on retail deposits of up to \$250,000 per depositor per ADI.

Foreign Investment Review Board (FIRB) – a non-statutory body established in 1976 to advise the Treasurer and the Government on Australia’s foreign investment policy and its administration.

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, which had

Financial System Inquiry — Final report

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 cooperation 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.

fiscal policy — Government spending and taxation policies that influence macroeconomic conditions.

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.

Group self-annuitisation (GSA) — in a GSA, participants contribute funds to a pool that is invested in financial assets. Regular payments from the pool are made to surviving members. GSAs allow pool members to share, but not completely eliminate, longevity risk and do not require capital to back guarantees.

Innovation Collaboration (IC) — a recommended public-private sector collaborative committee, to be chaired by Treasury to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.

insolvency — a situation where an entity has insufficient assets to cover the value of its liabilities, resulting in an inability to meet its financial obligations as they fall due.

International Monetary Fund (IMF) — an international organisation of 188 member countries that was established to promote international monetary cooperation, 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.

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.

Appendix 5: Glossary, acronyms and abbreviations

lender – a person or institution that provides loans on agreed terms to borrowers.

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 management – activities within a financial institution to ensure that holdings of liquid assets (for example cash, bank deposits and other financial assets) are sufficient to meet its obligations as they fall.

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.

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.

myGov – a secure single sign-on site that allows users to access a range of Australian Government services.

MySuper – low-cost, simple default superannuation products, established as part of the Stronger Super reforms announced in 2011.

Organisation for Economic Co-operation and Development (OECD) – a forum of industrial market countries that seeks to encourage economic growth, high employment and financial stability among its members 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.

Financial System Inquiry — Final report

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.

Productivity Commission (PC) — The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role is to help governments make better policies in the long term interest of the Australian community.

Reserve Bank of Australia (RBA) — Australia's central bank.

retirement phase — the period after an individual has retired from the workforce and qualifies for, and may be in receipt of, superannuation benefits.

Self-managed superannuation fund (SMSF) — a superannuation fund with fewer than five members, all of whom are trustees or directors of a corporate trustee.

simple bonds — bonds with 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.

small and medium-sized 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.

Stronger Super — the Stronger Super reforms were implemented in response to the Super System Review. Reforms include MySuper, SuperStream, strengthening governance and a number of measures relating to SMSFs.

SuperStream — a Stronger Super reform implemented on a transitional basis starting in 2013. The reform is aimed at improving the efficiency of the superannuation system. Under SuperStream, employers must make superannuation 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.