



MACQUARIE

Financial System Inquiry

Submission by Macquarie Group in
response to the Final Report

March 2015



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1. Introduction and Context

Macquarie Group appreciates the opportunity to respond to the Final Report of Australia's Financial System Inquiry (FSI), following its first and second round submissions in March and August 2014. The views reflected in those submissions remain current and we continue to believe that Australia's banking system is well regulated by international standards, largely due to proactive and rigorous supervision of Australian institutions that is focused on the prevention of systemic issues.

We concur with the Inquiry's assessment that the Australian financial system has performed well and that Australian authorised deposit-taking institutions (ADIs) are generally well placed in terms of capital levels, liquidity, asset quality, business models and governance. These are all crucial factors in ensuring that Australia's banking sector is robust to shocks and able to continue to provide essential services to the Australian economy. We also agree that concentration, and similarity of business models, in the banking sector increases the risk of financial contagion. We particularly support Recommendation 30 in the Final Report that regulators should be required to consider competition when designing and implementing regulation. Competition is relevant both within domestic markets and in terms of the international competitiveness of Australian ADIs. We encourage the authorities, when deciding on the best approach to implementing each FSI recommendation, to give careful consideration to both these aspects of competition.

Macquarie agrees with the Final Report that regulatory requirements for the Australian banking system that "policy makers should **avoid adopting unique Australian regulatory approaches** that are inconsistent with international practice".¹ This is essential in ensuring that Australia's financial system remains internationally competitive and that Australian ADIs are able to compete effectively for international funding. Australia remains a net importer of capital, with Australian banks having net international liabilities of \$343 billion as at June 2012.²

Since the publication of the Final Report, the Basel Committee on Banking Supervision (BCBS) has proposed fundamental changes to international capital standards with similar objectives to some of the Final Report's Resilience recommendations. In our view, this warrants a reconsideration of these recommendations once the international proposals are finalised, to avoid any unnecessary further deviation from, or duplication of, international standards. We also note that APRA's proposed framework for supervising Conglomerates has key departures from international standards and we propose that it is reassessed in light of the Final Report's recommendations.

As we have mentioned in our previous submissions to the Inquiry, Australia's banking system and prudential and regulatory frameworks have subtle but significant differences to many overseas jurisdictions. Whilst consideration of policy options and metrics from other jurisdictions is a healthy process, their adoption should always be subject to an objective assessment of whether these options are appropriate and workable in an Australian context and how the application of these options will affect the efficiency and effectiveness of our financial system. Furthermore, any policy changes should be carefully considered so as to prevent unintended consequences that may negatively impact the existing strength of the Australian financial system or Australian consumers. This includes careful consideration of the impact of any recommendations or amended policy settings upon Australian firms' ability to compete in domestic and international markets.

¹ Page 21, FSI Final Report, November 2014.

² Bailey, O., Van Uffelen, L., Wood, K., International Activities of Australian Banks, RBA Bulletin December 2012.

2. Summary of Comments

We broadly support many of the recommendations set out in the Final Report. As a result, we have provided comments in this submission only where we have specific input to provide on the implementation of a particular recommendation, or views on how a recommendation may be refined to better achieve an underlying policy objective.

As noted in 2009's Johnson Report³, our financial sector ranks highly in international surveys on many of the key requirements for a successful financial centre, yet our exports and imports of financial services are low by international standards. With the Australian economy adjusting to a change in the nature and size of the contribution made by the resources sector, it seems an appropriate moment to reconsider initiatives that support exports of financial services to other countries and promote Australia as a regional financial centre. Given the potential benefits to the overall Australian economy, the lack of specific recommendations that dealt with the international competitiveness of Australia's financial sector was disappointing. The Government's response to the Inquiry provides an opportunity for further progress in this area.

Resilience (see Section 3)

Recommendation 1: Capital levels

The Final Report recommends that capital standards are set such that Australian ADI capital ratios are "unquestionably strong".⁴

Macquarie agrees that Australian ADIs should be unquestionably strong and believes that they are. This strength reflects a combination of robust capital levels, liquidity, asset quality, business strategy, governance and risk management, supported by a robust regulatory framework. The strength of Australia's bank and regulatory ecosystem has resulted in Australia's banking sector being recognised as among the safest in the world.⁵ Responses to the Final Report's recommendations should recognise this strength and ensure that it is maintained.

We do not believe that setting capital requirements with reference to the capital levels of banks operating in foreign jurisdictions is workable or appropriate. Furthermore, this recommendation is best considered once revised international capital standards, and any policy response to Recommendation 2 (below), have been determined.

³ Australian Financial Centre Forum, Australia as a Financial Centre: Building on our Strengths, November 2009.

⁴ Page 41, FSI Final Report, November 2014.

⁵ For example, Standard and Poor's expect Australia to remain one of the safest banking systems out of 85 for which they publish banking industry country risk assessments. See Standard and Poor's, Australian Banking Sector Outlook: Stable, Although Some Game Changes on the Horizon, March 2015.

Recommendation 2: Narrow mortgage risk weight differences

The Final Report recommends that the average IRB mortgage risk weight is increased to narrow the difference between the average mortgage risk weight for ADIs on the IRB and standardised approaches.

Macquarie agrees that implementation of this recommendation should ensure that banks retain an incentive to adopt the IRB approach and the enhanced credit risk management techniques that sit alongside it. Macquarie believes this recommendation is best considered following finalisation of the recent BCBS proposals to introduce a capital floor and revised standardised approach.⁶

Recommendation 3: Loss absorbing and recapitalisation capacity

The Final Report recommends that APRA implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of ADIs and minimise taxpayer support.

Macquarie questions the need for additional loss absorbing and recapitalisation capacity for Australian ADIs, particularly in combination with unquestionably strong capital levels and uncertainty over the effectiveness of bail-in powers. Any new international minimum standards should only be adopted if they can be made workable in, and appropriate to, the Australian context without putting the existing strength of the Australian banking ecosystem at risk.

Recommendation 4: Transparent reporting

The Final Report recommends that APRA develop a reporting template for ADI capital ratios that is transparent against the minimum requirements of the Basel capital framework.

Macquarie supports this recommendation and has been working with APRA and the other internationally active Australian banks to establish a transparent, credible and auditable 'Basel Framework' capital ratio that is prepared using an APRA approved template. We recommend that this process is completed and implemented as soon as practicable.

Recommendation 7: Leverage ratio

The Final Report recommends that APRA introduce a leverage ratio that acts as a backstop to ADIs' risk-weighted capital positions, calculated in accordance with the Basel framework.

Macquarie is of the view that when implementing the leverage ratio, APRA should use the definition of capital as prescribed in the Basel framework rather than the APRA definition currently used in the relevant draft Prudential Standard.⁷ This would prevent Australian ADIs being placed at a competitive disadvantage relative to international peers and would be consistent with the BCBS goal of improved comparability between jurisdictions.

⁶ BCBS, Consultative Document, Capital floors: The Design of a Framework Based on the Standardised Approaches, December 2014, and BCBS, Consultative Document, Revisions to the Standardised Approach for Credit Risk, December 2014.

⁷ APRA, Draft Prudential Standard APS 110: Capital Adequacy, Attachment D, paragraph 1, September 2014.

Recommendation 8: Direct borrowing by superannuation funds

The Final Report recommends restoring the general prohibition on direct borrowing by superannuation funds using limited recourse borrowing arrangements (LRBAs).

Macquarie supports reasonable limits on the level of leverage within superannuation funds and believes that the Final Report's concerns regarding the potential risks of borrowing in superannuation funds can be addressed without requiring a general prohibition.

Innovation (see Section 4)

Recommendation 17: Interchange fees and customer surcharging

The Final Report recommends that interchange fee regulation is improved by clarifying the thresholds for when regulations apply, broadening the range of fees and payments that are regulated, and lowering interchange fees through the introduction of hard caps. It also recommends that surcharging regulation is improved by expanding its application and ensuring that customers using lower-cost payment methods are not over-surcharged.

Macquarie supports improving the effectiveness of interchange fee regulation and reducing cross-subsidisation between customer and merchant groups. Implementation of this recommendation should allow interchange fees to vary by product type to reflect the different costs of providing products to consumers. This ensures that consumers benefit from smaller, niche players being able to compete effectively with more diversified lenders.

Consumer Outcomes (see Section 5)

Recommendation 21: Strengthen product issuer and distributor accountability

The Final Report recommends the introduction of a targeted and principles-based product design and distribution obligation.

Macquarie supports initiatives to ensure that consumers are treated fairly and are able to make informed purchases. We agree with the Final Report that any new initiatives for product issuers and distributors should be implemented in a way that does not adversely impact product innovation. There should be further consultation on any new powers that are proposed in response to this recommendation.

Recommendation 22: Introduce product intervention power

The Final Report recommends the introduction of a product intervention power where there is a risk of significant consumer detriment.

Macquarie is supportive of appropriate measures to reduce potential consumer detriment from the purchase of inappropriate products. Any product intervention powers granted to ASIC should be clearly defined and limited, and should only be exercisable on the basis of transparent and well understood criteria.

Recommendation 24: Align the interests of financial firms and consumers

The Final Report recommends better alignment of 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 adversely affect the quality of financial advice.

Macquarie is supportive of measures to raise industry standards of conduct and professionalism. Macquarie supports industry action to reduce the potential for conflict of interest in life insurance remuneration, but cautions against initiatives that may impact the take up of life insurance in the community. We propose an alternative approach that meets the objectives of a competitive advice sector and a reduction in incentives for advisers to move policies each year.

Recommendation 25: Raise the competency of advisers

The Final Report recommends raising the competency of financial advice providers, with minimum standards including a relevant tertiary degree, and the introduction of an enhanced register of advisers.

Macquarie is supportive of raising the competency of financial planners across the industry, the introduction of a public register of advisers, and of ongoing professional development for advisers. We note the potential for an 'advice gap' for consumers if a tertiary degree requirement is implemented for existing advisers and propose an alternative transitional approach for these experienced advisers.

Regulatory System (see Section 6)

Recommendation 29: Strengthening ASIC's funding and powers

The Final Report recommends introducing an industry funding model for ASIC and providing ASIC with stronger regulatory tools, including substantially increasing maximum civil and criminal penalties to act as a credible deterrent for large firms.

Macquarie supports the Final Report's conclusion that ASIC should not introduce the extremely high financial penalties seen in some overseas jurisdictions. We feel that the current framework provides a credible deterrent. There should be industry consultation on any proposed changes to this framework in response to this recommendation.

Recommendation 30: Strengthening the focus on competition in the financial system

The Final Report recommends a review of the state of competition in the financial sector every three years, improved reporting of how regulators balance competition against their core objectives, identification of barriers to cross-border provision of financial services, and the inclusion of competition in ASIC's mandate.

Macquarie strongly supports the Final Report's focus on increasing competition, both within domestic markets and in terms of the international competitiveness of Australian ADIs. We note that APRA's proposed Conglomerates regime would impact the international competitiveness of Australian ADIs, as do regulatory requirements currently applying to Australian futures clearing brokers.

3. Resilience

Introduction

Macquarie recognises the importance of a resilient banking sector for the provision of essential services to the Australian economy. We welcome the review of this resilience and agree with the principle stated in the Final Report that “policy makers should **avoid adopting unique Australian regulatory approaches** that are inconsistent with international practice”.⁸ To comply with this principle and avoid unnecessary changes in Australian capital standards or further deviations from international standards, we advocate delaying the implementation of FSI recommendations that impact regulatory capital levels until international proposals to amend the Basel framework are finalised (likely during 2015).

Recommendation 1: Capital levels

Macquarie agrees that Australian ADIs should be unquestionably strong and believes that they are. This strength reflects a combination of robust capital levels, liquidity, asset quality, business strategy, governance and risk management, supported by a robust regulatory framework. The strength of Australia’s bank and regulatory ecosystem has resulted in Australia’s banking sector being recognised as among the safest in the world.⁹ Responses to the Final Report’s recommendations should recognise this strength and ensure that it is maintained.

We do not believe that setting capital requirements with reference to the capital levels of banks operating in foreign jurisdictions is workable or appropriate. Furthermore, this recommendation is best considered once revised international capital standards, and any policy response to Recommendation 2 (below), have been determined.

The Final Report recommends that “APRA should raise capital requirements for Australian ADIs to make ADI capital ratios unquestionably strong”.¹⁰ It goes on to recommend a “baseline target in the top quartile of internationally active banks”.¹¹

Macquarie agrees that Australian ADIs should be unquestionably strong and believes that they are. This reflects not only capital levels that are strong relative to the risk profile of their assets and operations, but also strong liquidity, asset quality, business strategy, governance and risk management, and a robust regulatory framework. The combination of these factors has resulted in Australian ADIs being globally recognised as unquestionably strong, for example: “Standard and Poor’s Rating Services expects that Australia will remain one of the lowest-risk banking systems among the 85 that have Standard & Poor’s banking industry country risk assessments”.¹² This existing strength should be taken into account when formulating a policy response to this recommendation.

⁸ Page 21, FSI Final Report, November 2014.

⁹ For example, Standard and Poor’s expect Australia to remain one of the safest banking systems out of 85 for which they publish banking industry country risk assessments. See Standard and Poor’s, Australian Banking Sector Outlook: Stable, Although Some Game Changes on the Horizon, March 2015.

¹⁰ Page 41, FSI Final Report, November 2014.

¹¹ Page 41, FSI Final Report, November 2014.

¹² Standard & Poor’s, Australian Banking Sector Outlook: Stable, Although Some Game Changes on the Horizon, March 2015.

Additionally, setting capital targets based on a mechanical linkage to the top quartile of the 102 Group 1¹³ banks per the BCBS Basel III Monitoring Report¹⁴ is, in our view, neither workable nor appropriate for the following reasons:

1. Australian bank minimum capital levels would change (up or down) every six months as the report is updated, creating uncertainty for ADIs and their investors, and could have a negative impact on bank funding markets;
2. The minimum capital levels of Australian banks should be appropriate relative to the risk profile of Australian banks, not the capital levels deemed to be appropriate by regulators of banks in other jurisdictions to address domestic considerations. Of the 102 Group 1 banks, fourteen (14%) are Japanese banks - were they required to hold additional capital due to a requirement isolated to the Japanese economy, this could require Australian banks to raise capital levels even where they are not exposed to the same risks;
3. Whilst explicit APRA super-equivalence relative to the Basel Framework can be adjusted for (as is proposed in Recommendation 4), there are other differences relating to the use of internal capital models that cannot objectively be adjusted for. Examples of this are:
 - a. EU implementation of the Pillar 1 capital floor¹⁵. This is a major constraint on a number of banks' capital levels, but is not reflected in their publicly disclosed Basel III capital ratios (and, we assume, the ratios used in the BCBS Basel III Monitoring Report).¹⁶ To the extent that some overseas regulators rely on this floor to prevent low capital requirements from unrealistically low IRB risk weights, this leads to disclosed Basel III capital ratios that suggest these banks are further above minimum regulatory capital requirements than is actually the case;
 - b. Active use of Pillar 2 capital requirements. For example, the UK has recently consulted on capital requirements for Pillar 2A.¹⁷ Whilst not explicitly mentioned, we assume that the BCBS Basel III Monitoring Report is based solely on reported Pillar 1 capital ratios and hence does not represent the full capital requirement.

BCBS proposals on a capital floor and revised standardised approach will likely change the relative positioning of different banks' capital ratio disclosures. Given these developments, we are firmly of the view that this recommendation should not be progressed until these international developments are finalised and a more up to date and consistent comparison of capital levels can be made. We are also of the view that this recommendation should be addressed after any policy response to Recommendation 2 has been finalised, as that may increase the capital levels of the Australian banking sector.

¹³ Group 1 banks are defined by the BCBS report as those banks that have Tier 1 capital in excess of €3bn and are internationally active.

¹⁴ This is compiled on a semi-annual basis, with the FSI Final Report referencing the BCBS Basel III Monitoring Report, September 2014.

¹⁵ This allows European countries to choose whether to apply the Basel I floor to capital requirements rather than RWAs. The Basel I floor was introduced as part of the Basel II framework and has been maintained in the Basel III framework. The floor prevents capital requirements falling below 80 per cent of the requirements under the Basel I framework.

¹⁶ For example, Swedbank's capital requirements increased from SEK 33,137m to SEK 66,092m under the Basel I capital floor as at December 2014. If this was factored into its reported RWAs, its CET1 ratio would fall from the reported 21.2% to 10.6%. See page 76, Swedbank Risk Management and Capital Adequacy Report: Pillar 3 – 2014. The BCBS Basel III Monitoring Report does not explicitly detail how capital floors are incorporated into banks' capital ratios for comparison purposes.

¹⁷ See Bank of England, PRA, Assessing Capital Adequacy under Pillar 2 – CP1/15, January 2015.

Lastly, Macquarie is of the view that Australian banks should be regulated on one measure of capital. It would not be appropriate or workable for Australian banks to be regulated on the basis of both the APRA and a 'Basel Framework' capital ratio.

Recommendation 2: Narrow mortgage risk weight differences

Macquarie agrees that implementation of this recommendation should ensure that banks retain an incentive to adopt the IRB approach and the enhanced credit risk management techniques that sit alongside it. Macquarie believes this recommendation is best considered following finalisation of the recent BCBS proposals to introduce a capital floor and revised standardised approach.¹⁸

The Final Report recommends raising the average mortgage risk weights of the IRB banks, to narrow the difference in mortgage risk weights between ADIs using the IRB approach and those using the standardised approach. The Final Report 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”.¹⁹ In determining the approach to narrowing the risk weight gap, “APRA should seek to maintain as much risk sensitivity in the capital framework as possible”.²⁰ The Final Report also notes that narrowing of mortgage risk weight differences “should be achieved in a manner that retains an incentive for banks to improve risk management capacity” and recognises “the differences in the risks captured by IRB and standardised risk weights”.²¹

Recommendation 2 rightly identifies the need to take into account any changes in the Basel framework in implementing this recommendation.²² Since the publication of the Final Report, the BCBS has proposed a capital floor and a revised standardised approach to credit risk, which will likely alter the average risk weight differential between IRB and standardised banks. Given these developments, Macquarie advocates that this recommendation should not be considered until finalisation of these BCBS proposals. This will avoid unnecessary deviations from the Basel framework requirements or duplication of capital requirements, and would be in consistent with the principle set out in the Final Report that “adhering to international regulatory norms will help ensure Australian financial institutions and markets are not disadvantaged in raising funds in international financial markets.”²³

In the case that changes to average IRB risk weights are still deemed necessary after finalisation of the international standards, the implementation approach should ensure that all banks adopting the IRB approach continue to see appropriate average risk weight benefits relative to the standardised approach. This is important in retaining an incentive for banks to invest in developing more sophisticated credit risk management, the importance of which is highlighted in both the Final Report and the Basel standards.²⁴ The implementation should also maintain risk sensitivity, as the ability to distinguish between the riskiness of different assets is a key strength of the IRB approaches.

¹⁸ BCBS, Consultative Document, Capital floors: The Design of a Framework Based on the Standardised Approaches, December 2014, and BCBS, Consultative Document, Revisions to the Standardised Approach for Credit Risk, December 2014.

¹⁹ Page 65, FSI Final Report, November 2014.

²⁰ Page 66, FSI Final Report, November 2014.

²¹ Page 60, FSI Final Report, November 2014.

²² Page 65, FSI Final Report, November 2014.

²³ Page xviii, FSI Final Report, November 2014.

²⁴ Page 4, BCBS, International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2006, and page 61, FSI Final report, November 2014.

The implementation approach should also give careful consideration to the objective of improving the competitive neutrality of capital regulation. This should include ensuring that any existing differences in average IRB risk weights across Australian ADIs not reflective of underlying risk are not amplified. For example, differences in average risk weights can reflect differences in modelling assumptions and data quantity. The introduction of a data sharing forum (as proposed in Recommendation 20) could help reduce these differences.

A competitively neutral outcome could be achieved by recalibrating the existing floor on the probability of default parameter at the pool level in banks' IRB portfolios.²⁵ This would be similar in spirit to APRA's loss given default floor and would help to ensure that an appropriate minimum amount of capital is held against mortgage exposures, protecting against model risk, whilst maintaining risk sensitivity above the floor. Alternatively, a floor could be applied to the average portfolio risk weight. This approach has been taken in Sweden and was adopted as a simple way of increasing capital held against mortgages without amplifying differences in firms' risk weights.²⁶

Recommendation 3: Loss absorbing and recapitalisation capacity

Macquarie questions the need for additional loss absorbing and recapitalisation capacity for Australian ADIs, particularly in combination with unquestionably strong capital levels and uncertainty over the effectiveness of bail-in powers. Any new international minimum standards should only be adopted if they can be made workable in, and appropriate to, the Australian context without putting the existing strength of the Australian banking ecosystem at risk.

Macquarie agrees with the Final Report that Australia should tread carefully in this area, as neither imposing losses on debtors nor converting debt to equity has been proven to be an effective method of resolving a bank in difficulty. Australia's financial system has remained resilient and effective through stern tests, reflecting a strong regulatory system and robust capital levels. We, therefore, question whether additional loss absorbing and recapitalisation capacity is necessary. Furthermore, international proposals for total loss absorbing capacity (TLAC) have so far been aimed at global systemically important banks (G-SIBs). Given that there are no G-SIBs in Australia, Macquarie is of the view that similar requirements are not required for Australian banks.

In addition, as highlighted in the Final Report, the use of bail-in powers may increase the likelihood of financial distress, by bringing forward the time at which creditors will seek to withdraw funds from a distressed institution and potentially from other, healthy, Australian banks.²⁷ This risk, which could undermine the stability of Australia's financial system, is heightened because of the level of offshore wholesale funding used by Australian banks.

If further work indicates that TLAC requirements are appropriate and workable in the Australian context and would not put the existing strength of the Australian banking ecosystem at risk, Macquarie's view is that bail-in powers should be limited to specifically defined liabilities and not be extended to deposits or senior debt. Hence, we would support the introduction of a new class of liability between Tier 2 debt and senior unsecured debt in the liability structure, with explicit contractual bail-in triggers, in order to provide certainty to investors. As highlighted in the Final Report, credible use of this loss absorbing and recapitalisation capacity is more likely where there are

²⁵ Prudential Standard APS 113, Attachment C, paragraph 2 sets out the existing 0.03% PD floor.

²⁶ See pages 52 and 56, Capital Requirements for Swedish Banks, Finansinspektionen, 8 May 2014, FI Ref: 14-6258.

²⁷ Page 74, FSI Final Report, November 2014.

clear triggers and mechanisms for when the instruments will absorb losses and these are clearly understood by investors at the time they invest in the instruments.²⁸ This is more likely to hold for contractual instruments than for broad statutory bail-in powers, where the latter could be applied to a wide range of unsecured debt instruments, including senior unsecured debt.

Recommendation 4: Transparent reporting

Macquarie supports this recommendation and has been working with APRA and the other internationally active banks to establish a transparent, credible and auditable 'Basel Framework' capital ratio that is prepared using an APRA approved template. We recommend that this process is completed and implemented as soon as practicable.

The Final Report recommends that “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”.²⁹ The objective is to “reduce disadvantages that may arise for Australian ADIs due to difficulties in comparing Australian ADI capital ratios to international peers”,³⁰ although the report notes that it is “not practically possible to compute a comparison to the practices of other jurisdictions”.³¹

Macquarie supports this recommendation and has been working with APRA and the other internationally active banks to establish a transparent, credible and auditable ‘Basel Framework capital ratio’ that is prepared using an APRA approved template. We agree with the Final Report that it is not possible to adjust objectively for the practice of other jurisdictions, and, therefore, support the development of an APRA approved template based on the Basel framework as the most credible approach. Development of this ratio will be an important step in providing ADIs with a disclosure tool to explain to investors some of the key differences between their reported APRA capital ratios and the ratios that banks from other jurisdictions publish. Having APRA’s approval and input into developing a template gives the disclosure credibility with international investors and ensures consistency between the Australian banks in terms of the adjustments made to the APRA capital position. We, therefore, recommend that APRA complete this process.

Whilst this proposed template is an important step towards increasing comparability of capital levels across banks, comparability issues would still persist, due to differences in modelling approaches and conservatism between different banks and jurisdictions. Macquarie welcomes the work being carried out by the BCBS to improve the comparability of capital ratios across jurisdictions. We note that even when this work is complete, the template will still be necessary to disclose to investors the impact of explicit APRA super-equivalence on Australian ADI capital ratios.

²⁸ Page 68, FSI Final Report, November 2014.

²⁹ Page 76, FSI Final Report, November 2014.

³⁰ Page 76, FSI Final Report, November 2014.

³¹ Page 77, FSI Final Report, November 2014.

Recommendation 7: Leverage ratio

Macquarie is of the view that when implementing the leverage ratio, APRA should use the definition of capital as prescribed in the Basel framework rather than the APRA definition currently used in the relevant draft Prudential Standard.³² This would prevent Australian ADIs being placed at a competitive disadvantage relative to international peers and would be consistent with the BCBS goal of comparability between jurisdictions.

The Final Report recommends that APRA should introduce a leverage ratio as a backstop to ADIs' risk-weighted capital positions and should be calculated in accordance with the Basel framework.³³ Macquarie supports the recommendation that the risk based capital requirement should continue to be the primary capital measure.³⁴ Consistency with the Basel Framework is important in ensuring that investors can transparently compare leverage ratios across jurisdictions. Any 'super-equivalence' in APRA's definition of capital, as currently proposed,³⁵ would place Australian banks at a disadvantage to international peers. Hence, we strongly recommend that APRA introduces the leverage ratio using the Basel framework definition of capital, not the APRA definition.

APRA should also seek to ensure that the leverage ratio only includes balance sheet items that truly represent bank leverage. For example, there have been concerns raised at an international level over the treatment of segregated initial margin³⁶ held by clearing firms in the calculation of the leverage ratio.³⁷ Macquarie shares these concerns and notes that failure to address these issues could substantially increase the cost, or reduce the availability, of clearing services.

Recommendation 8: Direct borrowing by superannuation funds

Macquarie supports reasonable limits on the level of leverage within superannuation funds, but believes that the Final Report's concerns regarding the potential risks of borrowing in superannuation funds can be addressed without requiring a general prohibition.

The Final Report recommends restoring the general prohibition on direct borrowing by superannuation funds using limited recourse borrowing arrangements (LRBAs). This is to prevent the unnecessary build-up of risk in the superannuation system and the financial system more broadly, and to ensure that superannuation is a savings vehicle for retirement income, rather than a broader wealth management vehicle.

Macquarie supports the introduction of reasonable limits on the level of leverage within superannuation funds, but is of the view that the stated objectives could be achieved without going as far as a general prohibition on direct borrowing by superannuation funds. Leverage provides superannuation funds with flexibility to pursue a range of alternative investment strategies, and, if used correctly, can diversify a fund's assets, rather than increase concentration risk. Introducing a range of measures to ensure that risk levels are tolerable and that recourse is genuinely limited would preserve these benefits of leverage, while addressing the concerns raised in the Final Report.

³² APRA, Draft Prudential Standard APS 110: Capital Adequacy, Attachment D, paragraph 1, September 2014.

³³ Page 84, FSI Final Report, November 2014.

³⁴ Page 85, FSI Final Report, November 2014.

³⁵ See APRA, Draft Prudential Standard, APS 110: Capital Adequacy, September 2014.

³⁶ A clearing firm provides a guarantee to the central counterparty (CCP) that the end user of a derivative contract will meet its obligations. The end user posts collateral with the clearing firm for the benefit of the CCP, reducing the extent of the guarantee provided by the clearing firm. This segregated initial margin cannot be used by the clearing firm to increase leverage.

³⁷ For example, see speech by U.S. Commodity Futures Trading Commission Chairman Timothy G. Massad to the Institute of International Bankers, 2 March 2015.

4. Innovation

Introduction

Macquarie is supportive of the Inquiry's objective of ensuring that policy settings facilitate future innovation in Australia's financial system that benefits the wider economy. This is important in ensuring that the banking sector provides the best possible services to its customers and in maintaining Australia's competitive position, both in financial services and other industries.

Recommendation 17: Interchange fees and customer surcharging

Macquarie supports improving the effectiveness of interchange fee regulation and reducing cross-subsidisation between customer and merchant groups. Implementation of this recommendation should allow interchange fees to vary by product type to reflect the different costs of providing specific products to consumers. This ensures that consumers benefit from smaller, niche players being able to compete effectively with more diversified lenders.

The Final Report recommends a range of measures to improve the transparency and efficiency of interchange fee regulation. One of these measures is "replacing three-year weighted-average caps with hard caps, so every interchange fee falls below the interchange fee caps".³⁸

Macquarie is supportive of the objectives of improving the effectiveness of interchange fee regulation and reducing cross-subsidisation between customer and merchant groups. It is important that the implementation of this recommendation allows interchange fees to vary by product type to appropriately represent the different costs of providing specific products to consumers and ensure ongoing competition in the market. Variety in product offering is of genuine value to consumers and should not be discouraged through overly restrictive price caps.

In particular, any system of hard price caps would need to recognise that corporate, business and premium products are more expensive for service providers to offer to customers. For example, corporate and business cards have higher incremental costs, including greater reporting to corporate clients, data integration services, and GST reporting. If caps on these products do not allow these costs to be recovered, service providers would have to reduce costs (for example, through reducing services), increase monthly fees, or limit product choice. Under a single cap, larger lenders, whose card portfolios are reflective of the market, may be able to continue to offer a wide range of products by cross-subsidising more expensive products, whose interchange fee would need to reduce, through increased interchange fees on more basic products. This would not be possible for smaller, niche card providers, reducing competition in the market, which would be detrimental for consumers.

The Inquiry also discusses a transparent publication of thresholds for designating which system providers would be subject to interchange fee regulation, potentially based on the system provider's annual transaction value and market share. Macquarie is supportive of this more transparent approach and the objective of enhancing competitive neutrality across system providers.

Macquarie also supports the Final Report's recommendation to expand surcharging regulation. Lower fees for low and medium cost system providers, including debit and credit cards, would

³⁸ Page 168, FSI Final Report, November 2014.

encourage consumers to make the optimal use of these payment methods, with fees better reflecting the actual costs of making the transactions.

5. Consumer Outcomes

Introduction

Macquarie is strongly supportive of measures to improve the treatment and financial awareness of consumers. Events over the global financial crisis have highlighted some shortfalls in these areas in a number of jurisdictions. Any policy changes need to be carefully designed to be in the best interests of all consumers and to avoid any adverse impact on competition.

Recommendation 21: Strengthen product issuer and distributor accountability

Macquarie supports initiatives to ensure that consumers are treated fairly and are able to make informed purchases. We agree with the Final Report that any new initiatives for product issuers and distributors should be implemented in a way that does not adversely impact product innovation. There should be further consultation on any new powers that are proposed in response to this recommendation.

The Final Report recommends the introduction of a targeted and principles-based product design and distribution obligation. This obligation would require product issuers and distributors to consider the type of consumer whose financial needs would be addressed by the product and the most suitable distribution channel, and would cover the product design, distribution and after sale processes.

Macquarie supports initiatives to ensure that consumers are treated fairly and are able to make informed purchases. The Final Report notes that “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”.³⁹ Macquarie agrees, and recommends that the implementation is done in a way that will not adversely impact product innovation. Given this risk, further industry consultation is strongly advocated.

Recommendation 22: Introduce product intervention power

Macquarie is supportive of appropriate measures to reduce potential consumer detriment from the purchase of inappropriate products. Any product intervention powers granted to ASIC should be clearly defined and limited, and should only be exercisable on the basis of transparent and well understood criteria.

The Final Report recommends an amendment to the law to provide ASIC with a product intervention power. This is designed to equip ASIC with the power to proactively reduce the risk of significant detriment to consumers arising from them buying products that they do not fully understand. ASIC would be able to amend marketing, add warnings, ban or restrict the distribution of products, without the need for a demonstrated or suspected breach of the law.

The Final Report rightly recommends a high level of accountability for the use of this power. In our view, it should be clearly defined and limited, and should only be exercisable on the basis of transparent and well understood criteria. This would include, but would not be limited to, the potential scale of consumer detriment and the scope of the consumer base exposed to the product. ASIC should also be subject to a high level of accountability for its exercise of the power. The

³⁹ Page 204, FSI Final Report, November 2014.

recommendation should also be balanced against the Government's policies of cutting red tape and supporting the growth of Australian industry in Asia. In addition, there should be further consultation on the detailed design of any new product intervention powers.

Recommendation 24: Align the interests of financial firms and consumers

Macquarie is supportive of measures to raise industry standards of conduct and professionalism. Macquarie supports industry action to reduce the potential for conflict of interest in life insurance remuneration, but cautions against initiatives that may impact the take up of life insurance in the community. We propose an alternative approach that meets the objectives of a competitive advice sector and a reduction in incentives for advisers to move policies each year.

The Final Report recommends better alignment of the interests of financial firms with those of consumers, including by raising industry standards of conduct and professionalism, and by ensuring that remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.

Macquarie is supportive of measures to raise industry standards of conduct and professionalism. Macquarie has invested considerable resources to enhance the professionalism of advisers in Macquarie's private wealth business, and to increase the effectiveness of associated risk policies, processes, controls and systems. These measures are set out in more detail in Macquarie's Submission to the Senate Economics Committee on the Inquiry into the Scrutiny of Financial Advice,⁴⁰ which also sets out Macquarie's support for a number of initiatives to further increase industry standards. In addition, we would also support the introduction of a code of conduct for advisers.

The Final Report notes the prevalence of high upfront commissions for life insurance advisers, reflecting the high arranging costs for life insurance products, and recommends a level commission structure.⁴¹ Macquarie supports industry action to reduce the potential for conflict of interest in life insurance remuneration, but cautions against initiatives that may reduce take up of life insurance in the community. In particular, under a level commission structure, many advisers who are sole proprietors or small businesses independent of insurance providers would not be able to absorb the considerable upfront costs of providing advice in the first year, reducing the amount of advice available to consumers. This reduction in available advice would be particularly acute for less wealthy consumers who take out less cover, as the upfront costs for advice to lower premium consumers represents a higher percentage of the customer premium.

In Macquarie's view, the recommendation in its current form would threaten the sustainability of independent advisers. Independent insurers, including Macquarie, use flexible payment structures to support their business model of relying on third party advisers. The recommendation would, therefore, deliver more market power to vertically integrated insurance companies which control large, aligned distribution forces. This would not be consistent with a key theme of the FSI, including Recommendation 30, of ensuring that regulation should appropriately consider competition. In particular, in its current form, this recommendation would likely increase both concentration and vertical integration, both of which are highlighted as potential concerns in the Final Report.⁴²

⁴⁰ Macquarie Submission to the Senate Economics Committee: Inquiry into the Scrutiny of Financial Advice, December 2014 ([link](#)).

⁴¹ Page 220, FSI Final Report, November 2014.

⁴² Pages xvi, 19 and 255 FSI Final Report, November 2014.

To balance the objectives of a competitive advice sector that can meet the requirements of all consumers, while reducing the high upfront incentives for advisers to move policies each year, Macquarie believes that any remuneration framework should recognise that financial advisers legitimately incur higher costs in the first year of a new policy. Rather than mandating a level structure, Macquarie believes that by capping the percentages available (as well as including minimum and maximum payments on any one policy), a new remuneration framework can be implemented through an Industry Code of Practice that would balance these objectives.

Macquarie notes that there is also a recommendation to review remuneration practices for stockbrokers. Stockbroking activities, like advice on other Tier 1 products, are provided pursuant to the best interest duty and broader FOFA requirements. Stockbroking commission differs from the commission income that FOFA was designed to remove in that the fees are paid by the client, not the product provider. Given these features, and the recommendation to raise the competency of advisers, we do not believe that amendments to stockbroker remuneration practices would have a significant effect on the quality of advice.

Recommendation 25: Raise the competency of advisers

Macquarie is supportive of raising the competency of financial planners across the industry, the introduction of a public register of advisers, and of ongoing professional development for advisers. We note the potential for an ‘advice gap’ for consumers if a tertiary degree requirement is implemented for existing advisers and propose an alternative transitional approach for these experienced advisers.

Macquarie is supportive of raising the competency of financial planners across the industry, the introduction of a public register of advisers, and of ongoing professional development for advisers. On the latter, in addition to the Final Report’s recommendations, we would support the introduction of an industry body to determine ongoing training requirements and an annual examination to ensure for advisers’ ongoing competency.

For new advisers providing personal advice on Tier 1 products, Macquarie supports the introduction of:

- minimum educational requirements of a relevant degree level qualification;
- mandatory ethics training;
- a registration exam;
- mandated professional association membership; and
- an annual requirement for 30 hours of continuing professional development (CPD).

To help manage the potential for an ‘advice gap’ highlighted in the Final Report⁴³, Macquarie agrees that a transitional approach should be considered for existing advisers providing personal advice on Tier 1 products, and accordingly that further industry consultation should be undertaken.

⁴³ Page 225, FSI Final Report, November 2014.

6. Regulatory System

Introduction

Macquarie supports measures to improve the regulatory system and in particular recognises the importance of ensuring that regulators appropriately consider competition when developing and implementing policies.

Recommendation 29: Strengthening ASIC's funding and powers

Macquarie supports the Final Report's conclusion that ASIC should not introduce the extremely high financial penalties seen in some overseas jurisdictions. We believe the current framework provides a credible deterrent. There should be industry consultation on any proposed changes to this framework in response to this recommendation.

The Final Report recommends the introduction of an industry funding model for ASIC and providing ASIC with stronger regulatory tools, including substantially increasing maximum civil and criminal penalties to act as a credible deterrent for large firms.⁴⁴ The Final Report notes, however, that it should not introduce extremely high penalties, as seen in some overseas jurisdictions.⁴⁵ It also recommends that ASIC should be able to seek disgorgement of profits earned as a result of contravening conduct.⁴⁶

Macquarie supports the Final Report's conclusion that ASIC should not introduce the extremely high penalties seen in some overseas jurisdictions. We note that some international regulators formally tier penalties so that the maximum penalty can only be imposed in very limited circumstances.⁴⁷ Furthermore, Macquarie believes the current framework of financial sanctions does provide a credible deterrent. Given this, it is not clear that there would be additional benefits to introducing substantially higher penalties. As a guide, fines should not be inconsistent with those that can currently be applied by the Australian Competition and Consumer Commission (ACCC).

Recommendation 30: Strengthening the focus on competition in the financial system

Macquarie strongly supports this recommendation, which has implications for the implementation approach of a number of the other recommendations in the Final Report. We also note that APRA's proposed Conglomerates regime would impact the international competitiveness of Australian ADIs, as do regulatory requirements applying to Australian futures clearing brokers.

The Final Report recommends that regulators demonstrate that they have explicitly considered the trade-offs between competition and other regulatory objectives when designing regulations. It also recommends that the Government commission external reviews of the state of competition in the financial system every three years, and that "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

⁴⁴ Page 250, FSI Final Report, November 2014.

⁴⁵ Page 252, FSI Final Report, November 2014.

⁴⁶ Page 250, FSI Final Report, November 2014.

⁴⁷ For example, the SEC and FDIC formally tier their financial penalties.

identified".⁴⁸ The Final Report also recommends that the Government should update ASIC's mandate to include a specific requirement to take competition issues into account.

Macquarie strongly supports the Final Report's focus on increasing competition, both within domestic markets and in terms of the international competitiveness of Australian ADIs. We also agree that it is important that regulators robustly demonstrate that they have explicitly, and appropriately, considered the trade-off between competition and other regulatory objectives when making policy choices.

We also share the concern raised in the Final Report that concentration and increasing vertical integration could limit the benefits of competition in the future. We recommend that the authorities give due consideration to this concern when implementing the other recommendations in the Final Report.

Macquarie also has concerns about the impact on international competitiveness of two areas of regulation that are not touched on in the Final Report, which should be reviewed in light of this recommendation. The first is APRA's proposed Conglomerates regime, which would be a further deviation from international regulatory standards and would negatively impact the international competitiveness of Australian ADIs, for example in relation to funds management activities.

The second relates to barriers to international competitiveness for Australian futures clearing brokers from inconsistencies in Australian and foreign client money rules and the requirement that offshore clearing facilities are subject to Australian clearing and settlement facilities licensee obligations in order to accept Australian clearing brokers as members. These regulations can result in Australian clearing brokers being unable to provide the same services to Australian clients as foreign clearing brokers. Given that more onerous regulatory requirements are reducing the willingness of financial firms to provide essential clearing services, it is important that any unnecessary regulatory barriers to this intermediation are removed.

⁴⁸ Page 254, FSI Final Report, November 2014.