Deloitte Access Economics

Shaping the future
Financial System Inquiry

Deloitte submission to the Interim Report
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Overview

1 Framework and principles

The Interim Report is a wide ranging review. A central theme of the report is the role that regulation plays in encouraging effective competition in the financial sector. This has clearly guided the Inquiry's thinking throughout the considerations and questions the Report poses. We support the Inquiry's focus on competition as a cornerstone for the regulatory framework, matched with suitably well-crafted prudential and consumer protection rules.

The Inquiry, as indicated by the Interim Report, will focus on how the financial system has evolved since the Wallis Inquiry, the lessons from the GFC, and how to modify the regulatory framework to best cope with future challenges. Consideration of potential future challenges will be important in implementing regulatory changes to strengthen the resilience and effectiveness of the regulatory framework. Technology, an ageing population, and further globalisation are set to result in profound changes in the economy and society over the next 10-20 years, and the nation will gain most from these changes if we have a robust financial system that can facilitate change. Accordingly, Deloitte's response to the Interim Report has been prepared with an emphasis on the nature of possible future developments and their implications for regulation.

Our response includes:

- An overview of five central sets of considerations that Deloitte thinks should be central to the Inquiry's final recommendations.
- A presentation of six future scenarios that have been developed as a way of testing possible pressures for the regulatory system going forward.
- Responses to select policy options and requests for information set out in the Interim Report. These responses are presented in the order in which they were noted in the Interim Report.

1.1 Australia's financial system

The financial system is central to a well-functioning economy. Its roles include:

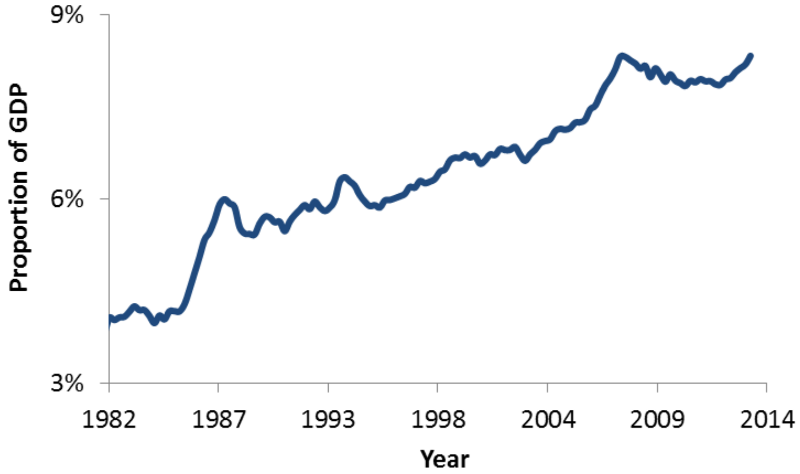
- matching savings with investment needs throughout the economy;
- enabling the allocation of risk to those parties best able to manage and bear it; and
- facilitating payments.

How well the financial system performs these tasks is the primary basis for judging its effectiveness.

Two sets of tensions arise when considering regulation designed to meet these goals. First is the balance between achieving a sound, stable system and encouraging innovation and competition, both in the financial sector and the wider economy. Further, finding this balance is a continuing and evolving challenge, particularly with the dual trends of technological advances and increasing globalisation. Secondly, a large and increasing share of Australia's resources is being devoted to providing financial services.

The sector accounts for over 8% of GDP today and that share is set to rise significantly because of the impact of the growth in superannuation on wealth management and related services (Chart 1.1). Over the next 20 years, superannuation assets are forecast to grow from around 100% of GDP to the equivalent of 180% of GDP.[1] Any reforms that improve the efficiency of the sector have the potential to positively impact national productivity. However, such efficiency gains would be ephemeral if they were to compromise its effectiveness in supporting consumers and the broader economy.

Chart 1.1: Proportion of GDP attributable to Financial and Insurance Services



1.1.1 The changing role of the financial sector

The financial services sector has been assuming a larger part of the nation's GDP ever since deregulation began in the 1980s. While there are a number of factors behind this growth, it appears to be driven in large part by two main welfare-improving forces:

- the growth in lending services that has accompanied the much improved access to credit that deregulation delivered; and
- the significant expansion of wealth management services that has flowed from the development of Australia's individualised national superannuation system.

While proportionally more resources are being devoted to lending activities than had been the case before deregulation, this has clearly had a positive effect. A much higher proportion of Australian society is now able to decide to borrow and invest in ways that suit their aspirations. The improved access to credit has resulted in the household sector becoming more highly geared, which has implications for sustainability. Unless accompanied by excessive borrowing, this is a supply issue that can only be addressed outside financial regulation. Otherwise, monetary policy has proved effective in easing pressure in the past, backed up by maintaining good lending standards and effective APRA supervision.

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[1] Deloitte (2013) *Dynamics of the Australian Superannuation System* http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Deloitte_Dynamics_of_Superannuation_2013_report.pdf

The message for wealth management is similar, but with the added observation that the proportion of resources devoted to these activities is set to rise further over the next few decades. In particular, by 2033, superannuation assets are projected to grow to $7.6 trillion.[2]

While the growth in the size of the superannuation and wealth management sector has increased focus on the fees consumers pay, these fees need to be looked at in conjunction with the benefits individuals receive in terms of advice, flexibility and choice. A reduction in fees which also results in a reduction in these benefits, could ultimately be to the detriment of consumers.

It is important that the Inquiry focus on the benefits that are being engendered by the expansion of financial services, especially in terms of access to credit, advice and retirement incomes tailored to the individual, in assessing the costs of financial services.

Looking forward, determining how the financial system can best be refined to continue to support the economic and social demands of Australian individuals and businesses in a cost effective manner requires careful calibration of regulation across the financial sector. It will involve making effective use of competition and minimising unnecessary compliance burdens. Our comments in the following sections are made with an eye to getting this balance right.

1.2 The regulatory framework - putting principles into practice

1.2.1 Principles

There is a clear, continuing, and important rationale and mandate for regulating the financial sector, and financial services more broadly. Both are central to individuals' lives and the ongoing functioning of the economy. Regulation – from consumer protection to macro-prudential requirements – has an important role to play in ensuring ongoing confidence in, and stability of, the financial system. Good regulation is vital.

However regulation, and the compliance burden that accompanies it, comes at a cost. An unduly onerous regulatory or supervisory system risks adding unnecessary costs and restricting innovation throughout the economy. Indeed, the burgeoning of compliance throughout the sector is an important factor behind the growth in resources devoted to financial services as shown above. Good regulation must carefully consider this balance. Specifically, it should be demonstrably welfare enhancing. Overall, **a regulation should only be enacted if its benefits outweigh its costs**. This principle of good regulation is widely espoused and was articulated clearly in the Wallis Inquiry.

The Wallis Inquiry advocated a principles-based approach to regulation emphasising **competitive neutrality**, **cost effectiveness**, **transparency**, **flexibility** and **accountability**.

[2] Deloitte (2013) *Dynamics of the Australian Superannuation System*. http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Deloitte_Dynamics_of_Superannuation_2013_report.pdf

The extent of intervention should be graded according to the nature of the contract involved and the consequences of market failure. For example, on prudential regulation, Wallis states:[3]

"As a general principle, financial safety regulation will be required where promises are judged to be very difficult to honour and assess, and produce highly adverse consequences if breached. … promises which rank highly on all three characteristics are referred to as having a high 'intensity'. The higher the intensity of a promise, the stronger the case for regulation to reduce the likelihood of breach."

The Interim Report outlines the general principles for government intervention:

- Outcome focused
- Forward-looking
- Cost-effective
- Competitively / technologically neutral
- Targeted and proportionate
- System-wide approach
- Transparent
- Accountable / independent

These principles are sound, and many echo those set out by the Wallis Inquiry. We broadly support these principles; in addition a multi-faceted approach is needed, directed at:

- embedding the **principle** of a less interventionist approach, where regulators only address well-defined problems;
- seeking to **align** Australian regulations with international standards, unless there is a strong rationale to do otherwise;
- encouraging the **design** of less prescriptive regulation;
- ensuring that there are appropriate and effective **enforcement** mechanisms consistent with an emphasis on outcome-based regulation;
- ensuring that a **culture** consistent with an emphasis on outcome-based regulation is maintained within each of the financial sector regulators;
- boosting the **accountability** of regulators; and
- encouraging **regulated entities** to actively explore better ways of meeting the objectives of regulation.

1.2.2 Practice

The challenge in the Australian financial system has not been in the design of these principles; it has been in their implementation. While overarching principles have been well specified in legislation, they must also be translated into practice at the detailed operational level.

[3] Treasury (1997), *Financial System Inquiry Final Report*, p190. http://fsi.treasury.gov.au/content/downloads/FinalReport/chapt05.pdf

The Wallis Inquiry agreed with a general move towards less prescriptive, more principles-based regulation. However, in practice, this vision has not been met. The benefits from a principles-based approach to regulation are diffuse but substantial, while the costs of an unregulated risk materializing are concentrated and highly visible. As such, in the wake of the GFC and sovereign debt crises, Australia has seen more interventionist and rules-based regulation and regulators.

The results of this are clear. **Australia has ended up with prescriptive regulation, encouraging a compliance culture – both amongst the regulated and the regulators**.

The regulation adds to costs and is not conducive to innovation; for example, product disclosure statements (PDS) have not worked, but have added significantly to the compliance burden. A wide-range of regulatory changes have been introduced in recent years or are now being introduced – pre-GFC: the Financial Services Reform Act (FSRA) and Basel II; and post-GFC: prudential regulations for insurance, anti-money laundering and counter-terrorist financing (AML/CTF), Basel III, regulation of credit rating agencies, OTC derivative reforms and Future of Financial Advice (FOFA) reforms. In isolation, the call on resources to implement the individual changes may not be large, but the cumulative impact of these changes on costs is likely to have been significant.

It is important to assess whether the benefits of the new regulations have justified these costs. There is no clear framework for undertaking this task. However, our assessment is that **the pendulum has swung too far**. By losing sight of the principles, new regulations may increase costs, without creating sufficient benefits to justify them.

1.2.3 Deloitte's view - bridging the divide

This backdrop highlights the importance of the Inquiry in its final report reinforcing sound regulatory principles that will be appropriate not only today, but as the Australian economy responds to a changing economic landscape, over the coming decades. While we welcome the Interim Report's endorsement of the thrust of the Wallis Inquiry's principles, and broadly agree with the other principles it articulates, the challenge is not simply to articulate sound principles. Just as importantly, the Inquiry should consider how to strengthen the way these principles prevail in practice. In this regard, it is instructive to reflect on not only the principles set out in the Wallis Inquiry but also subsequent trends, such as further internationalisation of regulation.

In response to these challenges, we recommend a multi-faceted approach to developing a framework for regulation that will foster continual improvement, as discussed in Section 1.5.1. This will involve reconsideration of the **design** of some important pieces of financial sector regulation. Even more vital at this point is the need to improve the **accountability** of regulators and ensure an outcomes-based **culture** within which regulations are enacted.

A key to achieving this will to bolster the quality of accountability standards in regulatory bodies. The quality of the administration of regulation will crucially depend upon the experience and skills of regulators themselves.

The complexity of the activities of financial institutions – and the range of activity across different types of institutions – makes it extremely difficult for regulators to develop and maintain appropriate skills.

The HIH Royal Commission highlighted this as an important issue for APRA soon after it was established. The difficulty that regulators face in understanding and keeping pace with details of the businesses they regulate is of continuing concern for many regulated entities.

Going forward, appropriate countermeasures will be needed to resist overly prescriptive and burdensome regulation from being implemented. While the Council of Financial Regulators (CFR) has been effective, it is not the appropriate forum to address the accountability of regulators for the regulation they create. There are a number of alternative models for this role, each with its strengths and weaknesses, including:

- a Parliamentary oversight council, with an advisory board comprising stakeholders from across the industry and broader economy. However, this challenges the independence of the regulating agencies from the political process;
- a more active role for Treasury, coupled with publishing minutes of CFR meetings and suitable consultation periods, to facilitate public debate. This may compromise the co-operative nature of the CFR; and
- a separate Bureau comprising experts drawn from industry and academia, or an Ombudsman, charged with ongoing assessment of the efficacy of regulations. Regulators would object to being overseen by the industry they regulate.

Such a body would be charged with helping rebalance the regulation of the financial sector to more closely align with the principles espoused in the Wallis Inquiry.

While the Interim Report supports sound regulatory principles, and acknowledges the growth of prescriptive regulation and a compliance culture, it does not explore how regulation may be more effectively implemented and enforced. We encourage the Inquiry to explore how the implementation and enforcement of principles-based regulation can be enhanced and strengthened. The Council of Financial Regulators has been effective in coordination across regulators, however, it is not a natural forum for considering the accountability of regulators.

1.3 Competition as the cornerstone

The Interim Report identifies the importance of competition and innovation in the Australian financial system in promoting consumer welfare by widening consumer choice and inducing higher levels of technical efficiency. Specifically, the Report highlights the importance of low barriers to entry to sustain competition and innovation.

The Report highlights three particular aspects of competition:

- whether vertical (and horizontal) integration is, or will in the future be, adversely impacting competition;
- where regulation may be harming the aim of competitive neutrality; and
- why the level of switching in, notably, superannuation and insurance is not greater and whether improved information on fees would help.

The first two points are considered in this section, while switching in, is considered in relation to consumer outcomes in Section 1.4.

1.3.1 Concentration and vertical integration

Australia's financial system is not concentrated to a degree that would indicate problems for competition, whether this is considered by sector (banking, insurance and wealth management) or overall. For example, based on the measure preferred by the Australian Competition and Consumer Commission (ACCC), the Herfindahl-Hirschman Index (HHI), the main retail banking product markets in Australia are below the threshold level of 2000 that would signal further investigation is warranted.[4] Indeed, if anything, parts of the system including superannuation may be too fragmented and some consolidation – while not an easy task – may be beneficial in creating a more efficient sector and reducing costs for consumers.

Similarly, many consumers benefit from the convenience and efficiencies inherent in solely or predominantly using an individual financial institution. The trend towards vertically-integrated suites of services is a reflection of both the benefits that many consumers derive from managing fewer financial relationships and economies of scale and scope for providers. It is a reflection of a market in which competition is working effectively.

Of course, there is the possibility that a few players progressively dominate to the extent that the competition landscape is harmed. The key to mitigating against such a possibility is low barriers to entry for each of the market segments. In these circumstances, the profits that integrated service providers may be able to achieve will be capped by the entry or threat of entry of new players. For example, this is evident in the rise of specialised mortgage brokers and originators in recent decades, and in new providers offering online saving accounts, exerting pressure on the larger institutions. The development and increased use of digital technologies will act to keep entry barriers down in the future, just as it has with online savings accounts but on a wider scale, increasing the ability for new products and providers to place competitive pressures on incumbents.

The major parts of Australia's financial system are neither concentrated nor integrated to levels that should be a concern from a competition perspective. The trend towards greater concentration reflects the benefits consumers derive from accessing a bundled set of services and thus the presumption should be that this is likely to be accompanied by an improvement in welfare. The main competition issue going forward should centre on barriers to entry, including regulatory barriers. Technology will act to reduce most entry barriers over time.

1.3.2 Competitive neutrality

The Interim Report identifies instances of competitive non-neutrality presently existing in the financial sector. Broadly, they relate to:

- funding cost differentials between small and large ADIs, with larger institutions facing lower costs of raising funds due to
  - market perceptions of systemic importance and access to markets
  - the dislocation of RMBS markets in the GFC; and
- unequal regulatory treatment of competing products in the retail payments system.

[4] Deloitte Access Economics (2014) *Competition in retail banking* http://fsi.gov.au/files/2014/04/ABA_2.pdf

One source of funding cost differences identified in the Interim Report is the perception that large, systemically important banks (SIBs) benefit from the perception that they are 'too-big-to-fail'. The Interim Report canvasses a number of policy options to directly address the benefits that shareholders and creditors of SIBs enjoy because of this implicit protection. The policy options included in the Interim Report generally constitute additional costs and requirements to be imposed upon SIBs.

One method of mitigating funding advantages attributed to perceptions of an implicit government guarantee for SIBs is through ensuring that all institutions regardless of size can be resolved in an orderly manner without recourse to taxpayer funds. Recovery and Resolutions Plans (RRPs), often referred to as 'living wills', have been a common element of many of the proposals already issued by various regulatory and oversight authorities, globally and in Australia, to address perceptions that financial institutions, and particularly banks, are 'too-big-to-fail'. Before imposing additional regulatory requirements, consideration should be given to the effectiveness of the policy changes which have already been implemented.

The use of internal ratings-based (IRB) risk weights by larger banks that are better equipped to be authorised for their use gives them a capital advantage over smaller ADIs that use standardised risk weights. This is appropriate, as the additional discipline that IRB imposes on a lender increases the efficiency and stability of lending behaviour, reducing the riskiness of the activity and hence the required allocation of capital. However, it is important to also note that although capital is lower, the IRB approach entails significant cost, and so the cost advantage cannot be judged by the difference in capital alone; it is in fact smaller than that. Competitive neutrality should be addressed by encouraging, and, where appropriate, assisting, smaller ADIs to be authorised for IRB risk weights.

The decline in the size and liquidity of the RMBS market in Australia since the GFC reduced the ability of smaller lenders that rely on securitisation to fund lending, with some leaving the market. The return investors have demanded on these securities has remained at an elevated level, and represents a significant increase in funding costs for these lenders. Although direct intervention in the market (as occurred during the GFC) is not appropriate, measures that seek to address the lack of liquidity in the secondary market could help improve the competition for lending provided by this market segment.

To the extent that there is any perceived funding advantage attributed to the presence of an implicit government guarantee for systemically important banks, such effect should be addressed through ensuring that all institutions regardless of size can be resolved in an orderly manner reducing the likelihood of recourse to taxpayer funds. Smaller players should be encouraged and supported in the transition to the IRB approach, and analysis and implementation of measures to make the RMBS market more liquid should be considered. The issue should not be addressed through additional measures on the SIBs.

The direct regulation of credit card interchange fees has led to the inconsistent regulatory treatment of products offering nearly identical services. In particular, three-party companion cards mimic the four-party cards, but the lack of an explicit interchange fee means that they are not regulated.

This is despite the 'issuer rate' playing the same role as an interchange fee. These products have also avoided being designated as payment systems by the Payment Systems Board.

This unequal regulatory treatment has been driving market outcomes in the retail payments market. The market share of the three-party schemes has increased by around one third, while new entrants also appear to be on the verge of offering products that would compete for retail payments, but avoid the interchange fee regulations. The lack of competitive neutrality needs to be addressed. A simple way of restoring neutrality would be to remove interchange fee caps, especially given the rationale for regulating interchange fees in the cards market is weak and lacks theoretical support.

> **The regulation of interchange fees for four-party payment card schemes has led to the creation of essentially identical products that are able to avoid the fee regulation. This regulatory arbitrage is now driving outcomes in the market. Competitive neutrality can most easily and efficiently be restored by removing the caps on interchange fees.**

1.4 Focus on consumer outcomes

The Interim Report rightly emphasises consumer outcomes as a central aspect of improving the effectiveness of the financial system. Consumer outcomes take several dimensions, including providing services at fees that are fair representations of their value, and providing sufficiently high quality information and advice to ensure the financial system is best able to cater for individual needs.

1.4.1 Benefits, not just costs

The Interim Report raises the magnitude of fees – particularly in the superannuation industry – as a significant issue. It speculates that 40 basis points may be able to be taken out of fees with a range of initiatives. If this were the case, that would represent efficiency gains that would rival some of the major microeconomic reforms of the past.

However, it is important that the Inquiry consider fees in the context of the services provided and the benefits of those services. If higher fees are commensurate with a level of management and advice that more closely aligns with consumer preferences, this would represent an optimal outcome.

The Interim Report argues that fees for investment in superannuation are high in Australia compared with overseas schemes. However, directly comparing fees across jurisdictions in this manner is problematic. Previous analysis by Deloitte Access Economics conducted for the Financial Services Council (FSC) concludes that fees in Australia are not out of line with those prevailing overseas given the differences in the scope and role of the schemes.[5]

In particular, fees for Australian funds are heavily influenced by:

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[5] Brogden, J (2014) *Keynote Speech, Financial Services Council Conference*, http://www.fsc.org.au/downloads/file/SpeechesFile/2014_0807_KeynoteSpeechbyJohnBrogdenatFSCAnnualConference2014.pdf

1. the concentration on ‘growth’ assets including equities, infrastructure and alternative assets in their portfolios; and
2. the individualisation of the arrangements.

Managing equity investments in corporations or direct investments in infrastructure will generally involve more resources than investments in fixed income products, and those resources will show up in fees somewhere in the financial system. The concentration on growth assets aligns with the long time horizon that most investors are encouraged to adopt with their superannuation. It is also a reflection of how the Australian financial system has evolved to support investment in productive activities in the economy.

The degree of individual tailoring and more active management involved in these choices adds to operational and compliance costs. Importantly, this reflects the choice of individuals rather than a lack of productivity or efficiency in the sector, and should not therefore be taken to represent a net cost to Australians.

The Interim Report also identifies a perceived lack of willingness of customers to switch superannuation funds to take advantage of fee differences. However, the extent of switching between products would seem to reflect a lack of perceived benefits from doing so, rather than the explicit costs. For example, the Interim Report emphasises a desire to see more direct cost comparisons for superannuation products in the expectation that this would result in downward pressure on fees. Yet, today, most of the mass advertising between funds is centred on fee comparisons and so additional information may not have much impact on behaviour. Rather, consumers may be helped more by addressing some of the behavioural issues that influence financial decision-making (see Section 1.4.2 below).

Nonetheless, there may be options to reduce consumer fees without significantly reducing the benefits inherent in the current system. For example, presenting individuals with simplified investment options would help to reduce fees associated with providing individualised options, while still providing adequate choice. It is still early days; MySuper is one step in this direction, but more time is required to assess its effectiveness.

Recommendations aimed at cost reduction should focus on (i) reducing compliance costs; (ii) simplification, including opt-out arrangements for basic retirement income products; and (iii) the use of technology. Any such recommendation needs to be mindful of trade-offs with benefits.

1.4.2 Informed consumers: disclosure and information

A central tenet of the Wallis Inquiry was that the system should support comprehensive disclosure and financial literacy, under the premise that armed with this information, consumers would then be able to make decisions in their best interest. Putting this principle into practice has not met with success; in part because disclosure documents became an exercise in compliance and corporate risk management rather than clarity.

However, even if disclosure documents were to succeed in delivering information in a clearer manner – and there has been considerable effort aimed at doing just that since the initial FSR legislation – informed decision-making requires more. It requires effective mechanisms to deal with disengagement, complexity, potential cognitive biases, potential conflicting advice and financial literacy.

The challenge for the current Inquiry is to find mechanisms to support the consumer in a cost effective way that does not simply add more layers of regulation.

The solution to these challenges requires a combination of:

- continued efforts to improve consumer understanding through simpler messaging and technology;
- encouraging better product governance by issuers and intermediaries;
- careful supervision of investments, giving ASIC the power to ban inappropriate products; and
- supporting trustworthy, appropriate and cost-effective advice.

Looking ahead, the use of digital technologies provides a way for information to be distributed to investors in a simple and timely manner. Technology would allow the disclosure to be scalable and thereby provide the customer with the right amount of information at each point in the process. Along similar lines, we understand that ASIC is working with financial institutions exploring ways to encourage interactive processes whereby the information provided to consumers is dynamically adjusted depending on consumers' understanding of the messages being conveyed.

More generally, financial advice can take three main forms: product information (known as 'general advice'), advice on a specific issue (known as 'scaled advice') and advice which considers an individual's financial circumstances in a holistic manner (known as 'personal advice'). Given product complexity and low levels of financial literacy, access to the right advice in a cost-effective manner can significantly improve individual outcomes.

Incidents in recent years have seen public confidence in financial advice fall. Further, some consumers are not aware that they have access to cost-effective general or scaled advice through their financial service providers. Government can help to address these issues by introducing a public register of advisers and through stricter licensing requirements.

Individual preferences and needs are unique. Legislation should rely less on mandating universal solutions and more on nudging individuals and institutions toward better consumer outcomes.

1.4.3 Retirement incomes, retirement outcomes and risk management

Over the past 20 years, the development of a comprehensive superannuation system has represented a significant societal shift, moving the burden of funding retirement away from taxpayers collectively, onto individuals. The system has proved to be successful. And while safety nets provided by government remain, they are now needed for support by a decreasing proportion of society, a trend which will continue over time.

The increased role of superannuation has meant individuals are now required to assume more responsibility for managing their own risks, especially in retirement. As noted above, this can be complex and appropriate advice is important to achieve effective outcomes. More broadly, individuals need to manage other retirement-related risks, including those related to healthcare, longevity risk, and sequencing risk, taking into account both their labour and non-labour incomes. The management of these risks falls, to a significant extent, outside of superannuation portfolios.

In considering the role of the financial system in contributing to retirement outcomes in a holistic manner, the Inquiry could comment on:

- health insurance, that, unlike other insurance products, is not prudentially regulated by APRA, potentially allowing for an uneven playing field to emerge;[6]
- the lack of insurance products for aged care in Australia;[7] and
- the impact on financial advice – and the financial advice industry – from considering other retirement outcomes beyond superannuation and life insurance.[8]

Part of the solution to providing integrated advice across a broader range of retirement issues, may be services delivered through digital platforms.

The challenges facing retirees need be considered in an integrated manner including superannuation and other forms of savings, and health and aged care costs. Health insurance should be consider in the Inquiry, as should the potential role for aged care insurance.

1.5 Systemic issues

Balancing an efficient and competitive financial system with one that is systemically sound, will naturally result in trade-offs in determining the appropriate degree and scope of regulation. Recent experience has shown that prudential regulation in Australia has been strong and effective. However, the GFC, and the international response to it, have led to increased focus on regulating core elements of the financial system to ensure stability in a future financial crisis. While stability is important, there are costs and consequences of increasing stability. More onerous regulation on core activities may result in funds moving to the less regulated periphery of the system. It is also important to ensure that the impact of greater stability on competition and efficiency is understood and considered.

Technology is playing an increasingly important role in financial markets and will likely continue to do so in the future. While it provides significant advantages, both to financial intermediaries and consumers of financial products, it will be important to ensure that technology does not exacerbate the issues raised above, for example, by moving core activities out of sight of regulators.

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[6] For example, the Insurance Council of Australia makes the case for a regulatory level playing field for all insurance products in its submission to the Inquiry

Insurance Council of Australia (2014) *Submission to the Financial System Inquiry*. http://fsi.gov.au/files/2014/04/Insurance_Council_of_Australia.pdf

[7] The risks of increased expenses associated with aged care have many characteristics that lend themselves to an insurance product. However, there are practical challenges in developing such a product including how it would interact with public funding of aged care facilities. Its development seems to require action supported by government.

[8] Superannuation funds do encourage individuals to consider their desired levels of life insurance, but the consideration of broader risks does not go further than that. Advisers will incorporate all financial assets and liabilities into their considerations, but typically not all risks.

1.5.1 Prudential regulation and international integration

At the global level, international minimum standards are being or have been agreed. In the interest of consistency and to avoid regulatory arbitrage, Australia should implement these minimum standards unless there is a compelling argument as to why a given standard as drafted would be inappropriate. Given financial systems are increasingly connected, the principle of consistency is crucial in promoting key stakeholders' confidence and trust in the financial system. This should be the default position.

If international requirements change, this would be grounds for considering the costs and benefits of increasing capital requirements for Australian SIBs. Given the opportunity cost associated with withholding capital from the economy, any subsequent assessment of whether the capital requirements for domestic SIBs should be further increased would require a strong case as to why the existing levy is considered inadequate. Such an evaluation should consider that Australia's strong legal system, and effective prudential oversight, are arguments against the need for more onerous capital requirements.

Australia's legal framework and record of close, effective supervision means that our prudential standards should be no more onerous than those operating internationally.

1.5.2 Role of superannuation assets

The Interim Report rightly considers the important role that the superannuation sector plays in allocating funds through the economy. Funds under management have risen significantly since the last financial inquiry and will continue to do so for at least the next two decades.[9] The productivity implications of ensuring that the sector allocates funds to their most efficient use in the economy will therefore be significant in coming years. Deloitte considers that the superannuation sector is well placed to meet these challenges. A sector which maximises its ROI does so by placing funds to their highest value use.

As the Interim Report pointed out, supporting appropriate investment in key areas, such as infrastructure and SMEs will be important. In the past, the system has created suitable vehicles for shifts in funding like this to occur without needing big changes to regulation. It will be important for regulators to monitor the shift in funding over time to ensure productivity and stability goals are achieved. However, the low levels of direct gearing in superannuation, if maintained, including in SMSFs, will alleviate these risks to a large degree, as will the relatively long term focus of investments in superannuation funds.

Australia's financial system should be able to manage the shift to a progressively large share of assets being held by superannuation funds. The challenge will be for suitable intermediation to support the different activities in the economy. While it will be important to monitor shifts in funding over time, the low levels of direct gearing, if maintained, and long term focus will help to alleviate risks to financial stability.

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[9] Deloitte (2013) *Dynamics of the Australian Superannuation System*. http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Deloitte_Dynamics_of_Superannuation_2013_report.pdf

2 Future Scenarios

The financial system is at the heart of Australia's economy, facilitating all forms of commercial activity, affecting every business, almost every individual, and even Australia's relationships with the wider world. In coming decades, the big changes that will impact our economy and society will, along with the underlying regulatory environment, shape the future of the financial system.

It is possible that our system of banks, financial services, insurers and superannuation funds and our network of payments systems slowly evolve in response to the 'mega trends' that are on the horizon – the rise of Asia, greater digitisation, population ageing and climatic instability. But history tells us that change is rarely gradual and predictable. Instead, epochs are often defined by one or more major changes that fundamentally change the shape of our society over a relatively short period of time.

In shaping the future regulatory environment for the payments system, Deloitte's view is that an 'extrapolation view' of change is only one scenario, and that a range of other more disruptive scenarios are possible. Do the changes proposed by the financial system inquiry have the width of foresight to accommodate such scenarios? Deloitte has devised six scenarios to stress test thinking.

First, we acknowledge that **steady as she goes** is a possible if unlikely future. Australia gradually experiences growth in superannuation and greater use of digital technology in finance. The trend of rising costs of natural disasters continues. However, the basic concentrated structure of the industry persists, perhaps with some increased integration. The regulatory challenge in such an environment will be to allow innovation to prosper and to make sure consumers get the benefits of a balanced approach to competition and integration.

Asian Acceleration Inbound is another scenario, where the integration of Australia with Asia deepens with a Chinese financial institution, with extensive investment banking interests, acquiring one of the 4 pillars or Australian securities being listed on an Asian exchange. Besides the detailed issues such as data security, there are macro questions about international system stability if our financial system is more closely linked with less mature developing countries.

In the event of the failure of a G-SIFI that is also a pillar of Australian retail banking, the effectiveness of cross-border resolution and recovery mechanisms will be tested. Meanwhile, Australian corporate securities listed on large regional hubs will enjoy greater access to funds … and greater competition for funds, with internationally harmonised reporting making direct comparisons of securities in different countries easy. And consumers will have access to a smorgasbord of financial products manufactured in every country of the world, increasing the value of good financial advice.

On the other hand, deeper ties could see **Asian Acceleration Outbound**, with Australian financial institutions being more dependent on the economic and asset fortunes of Asia, and following that, Africa and Latin America. The consequences for prudential regulation standards are very significant. Alignment with global regulatory standards will be crucial to enable Australian FIs to compete on a level playing ground abroad.

The prospect of economic shocks being transmitted rapidly back to Australia from exposures of domestic FIs to overseas economies will come to the fore.

Digital and retail revolutions could reshape finance even more fundamentally, with all the key technology trends – online, social media, mobility, cloud, big data analytics – changing what finance is. Is robo-advice from a big data analytics program financial advice that needs to be regulated? Will big ICT companies trade personal information like a currency? Will technology break up financial services into so many small parts, it will hard to distinguish financial institutions from everything else? Regulators will have to be ready to adapt to changing circumstances, but the thinking on what a more digital financial system will look like can start now.

Will **technology** finally reduce information asymmetries and transaction costs to levels that no longer cause the market failures that governments and regulators strive to address? The prospect of consumers instantly switching between providers and products, in the ultimate show of the power of consumer choice, has the potential to be a powerful force for competition … and potentially a dangerous source of instability.

A **superannuation revolution** occurs as the growth of superannuation results in funds expanding the financial services they provide and becoming the core financial institution for some customers. Australia's huge capital base is used to drive the industry deeper into adjacent markets in health, aged care, and financial services. A world in which superannuation assets underpin the bulk of economic activity, with banks performing transaction services and product development, may provide a new level of stability in the system, but increases the focus on governance.

And finally, the horror scenario of **meltdown**. While the Global Financial Crisis exposed the vulnerability of the system, and the consequences of calamity, it reflected a series of intersecting but relatively modest problems with regulations, financial innovations, and credit ratings. The scope for a much larger meltdown is clear, with any one of a number of technology, sovereign debt, and developing country issues having the potential for a much larger wipe-out of global wealth. Deloitte is not predicting any such event, but is recommending policy designers have it in mind when redrafting regulations.

The table below describes these scenarios and some of the regulatory issues that follow. It is not exhaustive, but intended to lift the gaze of policy regulators from the business as usual world to a future that that could and indeed is likely to look much different from today.

Scenario	Impact	Potential regulatory considerations
STEADY AS SHE GOES	**This scenario extrapolates some existing trends whereby:** • Superannuation balances continue to grow along with the growth in the number of pension-phase retirees. • The number of entities operating outside the prudential perimeter expands, targeting niche customer groups • High levels of concentration remain in banking and insurance products, and concentration levels in superannuation increase. • The trend towards vertical and horizontal integration increases. • Technology progressively eases entry in certain parts of various market segments. • The trend of increasingly costly and frequent natural disasters continues. • Financial institutions expand into aged care related financial services • As financial institutions focus on profitable customers, enabled by analytics and technology, a growing proportion of the population encounter financial exclusion, or can only access basic financial products at a high cost	• Sustainable retirement income; need to improve consumer choices, through better advice, products and financial literacy. • Competition vs concentration, costs and benefits to consumers from integration • Innovation vs protection, ensuring prudential regulation does not stop risk taking and innovation, keeping barriers low • Increased regulatory focus on financial exclusion
ASIAN ACCELERATION INBOUND	**There is an increased economic footprint in Australia by foreign financial institutions, particularly Asian banks.** • A Chinese G-SIFI acquires one of the 4 pillars. • Core financial infrastructure are outsourced, e.g. with Australian securities listed on an Asian central exchange • Increased outsourcing of core technology and operations services offshore	• Globalisation vs contagion and stability • Effectiveness of recovery and resolution plans operating across borders • Transfer of personal data offshore • Consumer protection with an increase in offshore financial products sold in Australia

<table>
<tr><th>Scenario</th><th>Impact</th><th>Potential regulatory considerations</th></tr>
<tr><td>ASIAN ACCELERATION - OUTBOUND</td><td>Continued growth in Asia prompts Australian financial institutions to significantly expand their operations in Asia.
• Acquiring banks that are inherently more exposed to economic and asset market cycles in Asia than currently.
• The banks follow Asian clients as they expand into the Middle East, Africa and Latin America.</td><td>• Regulatory integration, mutual recognition of legal and regulatory standards
• Impact of local prudential regulation on Australian firms entering/competing in overseas markets.
• Transfer of personal data offshore
• Conduct risk and reputation risk increase with blurred boundaries on acceptable business practices in different cultures</td></tr>
<tr><td>DIGITAL AND RETAIL REVOLUTION</td><td>Digital and technological progress accelerates leading to:
• Non-financial institutions offering traditional banking products and services
• Stored Value cards issued by retailers and telecommunication companies become customers primary transaction account
• Organisational value being increasingly driven by data and the information about clients
• Disintermediation of the core banking system
• Real-time financial services
• Passive data collection
• Peer-to-peer retail lending and insurance
• Greater automation of processes and the digital bank
• Personal financial advice is provided by ‘robo-advisers’ based on big data
• Airline frequent flyer points become a default currency and become convertible to cash and can be used to pay for goods and services</td><td>• Prudential perimeter - blurring boundaries between service provider accounts (eg prepaid mobile accounts) and deposit taking
• Determination of when activities outside the prudential perimeter should be brought in.
• Consistent regulatory framework for similar activities
• Regulating financial service providers operating within a conglomerate, potentially with on-shore and off-shore components to the financial services delivered
• Data capture on financial service-like activities operating outside the prudential perimeter
• Questions arise on who the adviser is and how robo-advisers should be regulated
• Competition and stability implications of real time activity
• Flexible regulation, to accommodate unforseen innovation
• Determination of when currency-like arrangements, such as airline frequent flyer points, are included within the prudential perimeter</td></tr>
</table>

Scenario	Impact	Potential regulatory considerations
Super Revolution	**The growth of superannuation funds leads to a 'super-sized' superannuation sector.** This causes funds to move into traditional banking services, including direct deposit-taking and transactions. As funds focus on retirement outcomes as opposed to investment for retirement, this leads to an: • increased role in aged care, health insurance • increased use of alternative financial products including reverse mortgages and annuities • increased focus on managing sequencing risk Banks begin to operate more as service providers, offering mortgage origination and SME lending, while lending is securitised and sold on to superannuation funds. • Develop new instruments to get funds from super to borrowers, e.g. SMEs, infrastructure, start-ups.	• What products and infrastructure are needed for superannuation to take a greater role in funding activity • Increased provision of aged care and health insurance related products and services with focus on retirement outcomes v retirement income • Sheer size of superannuation requires tax redesign, challenge of micro-reform • Relatively larger superannuation to make financial system more stable? • Increased investment offshore by superannuation funds
Meltdown	**A Global Financial Crisis II is triggered by a combination of a**: • Global sovereign debt crisis • Natural disasters • Technology crisis that destroys asset values • A flight to quality challenges the business model of niche players and smaller financial institutions • The contagion spreads damage across insurers, lenders and investors. The scope of damage is intense and this time, Asia doesn't escape the worst of the damage.	• Ring-fencing and on-shoring of banking activities • Increased political pressure for directed investments to support the economy • Is infrastructure in place to 'jump start' domestic markets without taxpayer support? • User pays for insurance on FIs. • Foreign regulator/government wants to repatriate assets of Australian creditor banks • Adequacy of back-up systems, e.g. a cloud solution?

3 Summary of Recommendations

Specific recommendations where we recommend change to current arrangements, unless stated otherwise

Competition

Banking

Do not raise minimum IRB risk rates; instead, support helping others to move towards those.

Funding costs

We would recommend pursuing measures that would encourage improved liquidity in the RMBS market. This could be achieved by reviewing regulatory impediments to RMBS being treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio.

The concentration and integration of the major banks

Increased (vertical) integration in banking has been driven by consumer preferences and needs and, in general, is not causing competition issues or distorting the way in which mortgage brokers direct borrowers to lenders.

Lenders mortgage insurance

While global standards have not yet been formalised, aligning the LGD floor for insured loans would improve economic outcomes.

Payments sector

The current non-neutrality in the treatment of companion cards causes market distortions. Formal interchange fee regulation is inappropriate and should be removed. Monitoring and benchmarking should be used instead.

Surcharging regulations are focused on consumer protection rather than competition issues. Any surcharging regulations should be policed by regulators in targeted sectors as necessary.

Funding

Housing and household leverage

Action by financial sector regulators to mitigate the effects of developments in the housing market on the financial system and the economy should be limited to monetary policy and the occasional use of supervisory action by APRA.

Small- and medium-sized enterprises

Basic information asymmetries have persisted over time. It is possible that technological solutions can help reduce this, but there is not yet a strong evidence base for how cost-effective regulatory change could accelerate this.

Superannuation

Superannuation is going to grow substantially.

The growth in superannuation could result in superannuation funds funding an increased proportion of economic activity in Australia.

While the proportion of superannuation funds assets devoted to fixed income will increase, their investments in equities and alternatives will rise as a share of GDP.

The corporate bond market

Allowing listed issuers to issue vanilla bonds directly to retail investors would help the corporate bond market at the margin.

The growth in the number of older retirees is likely to result in an increase in demand for fixed income products and annuity–style products without requiring any additional incentives or regulatory changes. This demographic change will support the growth of fixed income markets.

Superannuation

Efficiency

It is important that the Inquiry focus on both benefits and costs when assessing the efficiency of the superannuation sector. A focus on fees and costs, without adequate consideration of benefits raises the risk that proposed policy interventions may result in adverse consumer outcomes.

Given that the MySuper changes have only recently been introduced, it is important to allow time to determine the outcomes of the MySuper super reforms before proposing additional changes..

Leverage

Restoration of the general prohibition on direct leverage of superannuation funds improves competitive neutrality and limits the tax advantages of superannuation to funds that have been saved and not borrowed.

Self-managed superannuation funds

The Inquiry should not be directly concerned about these high operating expenses per se; rather, it should take in to account the quality of advice SMSFs are receiving.

There are practical difficulties on imposing limitations on the establishment of SMSFs.

Stability

Imposing losses on creditors

Increasing the ability of regulators to impose losses on creditors will be difficult to effectively put into practice. As a result we would support no changes to current arrangements.

Resolution powers, pre-planning and pre-positioning

APRA should continue to engage with banks as it aligns Australia's recovery and resolution processes with international standards.

The global framework has been established, and should be allowed to run its course.

Capital requirements

Australia already has increased capital requirements for domestic systemically important banks which is in accordance with global responses. No further changes to current arrangements should be considered at this stage.

The Financial Claims Scheme

The existing threshold for the FCS is too high and should be reduced.

Ring fencing

There is currently no compelling reason to make changes to the current arrangements. Australia should continue to monitor global regulations on ring-fencing.

The prudential perimeter

The rationale for expanding the prudential perimeter should be based on a considered analysis of the costs and benefits. Meanwhile, in the spirit of preparedness over prediction, regulators should continue to closely monitor market developments (including institutions and activities) to see whether changes are warranted.

Macroprudential powers

Existing frameworks have proven sufficient for the management of macroprudential stresses in the economy, and absent concrete global standards Australia has no need to pursue such tools unilaterally.

Implementation of international prudential frameworks

Given the strength of the legal framework in this country, as well as the strength of supervision and effectiveness of enforcement, consistency with minimum regulatory requirements should be a starting point when new international standards are adopted in Australia unless there is a clear benefit from more conservative standards or faster implementation.

Corporate governance

There is no clear evidence to support why different duties should exist between directors of financial institutions operating in different parts of the financial system.

Consumer outcomes

Disclosure

Improving current disclosure requirements by leveraging technology to provide layered disclosure and online comparators would enhance consumer outcomes.

To support the changes in disclosure requirements, ASIC would be given additional powers, and the ability to enforce them, to ban inappropriate products.

Adviser competence

Raising minimum education and competency standards for personal advice would signal advisor competence, enhance trust and improve consumer outcomes.

Ensuring ASIC has adequate powers to ban individuals would strengthen the effectiveness of financial advice regulation.

Accessibility

A majority of consumers already have access to low-cost scaled advice. Technology could also be used to provide this at a larger scale and improve awareness. However, regulatory requirements appropriate to the nature and scale of the advice are necessary.

Independence

Consumers appear to be able to understand the difference between aligned and independent advisers and to consider this when making decisions.

However consumers are sensitive to the cost of independent advice. As a result access to low-cost scaled advice is important.

General advice

‘Sales’ or ‘product information’ is a more accurate reflection of the content, and would allow consumers to understand the context of any advice provided and make decisions accordingly.

The use of the term ‘advice’ should be restricted to personal advice that meets specific regulatory requirements.

Underinsurance

Greater investment in disaster mitigation measures will reduce the impact of underinsurance.

Regulatory perimeters

Retail payments systems regulation

A graduated framework for regulating retail payments is appropriate.

Regulator structure and coordination

Existing CFR arrangements contribute to effective regulatory coordination.

The Inquiry should recommend increasing accountability of regulators, to guard against the risk of excessive regulation.

Retirement income

Retirement income system

Changes which enable consumers to effectively manage their income and risk in retirement should seek to reduce complexity.

Retirement income products

Regulators should not mandate individual products, as individuals needs differ significantly.

The tax system could be used to encourage individuals to take an income stream rather than a lump sum.

Policies to encourage the development of products which enable consumers to effectively manage their income and risk in retirement should avoid increasing complexity.

Technology

Technology neutrality

Technology neutrality is a sound ideal, but there can be practical challenges to achieving it, so any work program to reform legislation and regulations should be realistic and phased over time.

Facilitating innovation

Australia has considerable innovation policy architecture for monitoring and advising government on technology and innovation; a new body or strategy is not needed.

Three areas the Inquiry could focus on are stored value, overlay services and new types of lending.

Privacy

Privacy regulation should be focused on informing and empowering consumers, not lots of rules. Improve data.gov.au by regularly updating data, having more location-specific assets and more information about insurance.

Data security and cloud technology

Mandatory breach notification is important for trust.

Cloud needs baseline controls which are reviewed regularly as the technology (and its associated security) is expected to change dramatically.

Cyber security

The Security Strategy should be updated.

There is value in a facilitated discussion forum. Australia needs to establish a standard and underpinning mechanism for cyber-threat and security event information sharing across all of Australia business and government, and also including high risk cloud and other outsourced services providers.

The implementation of a national cyber-security standard would provide Australian organisations with a common and pragmatic measure of current and planned cyber security capabilities and maturity.

Digital identity

There is a clear market need for an independent mechanism to verify the authenticity of person, particularly online. Social networks have the potential to be as valuable in confirming an identity as a passport. Whether a business or government service, it is important that the consumer, or citizen, receives fair value for using social media to identify themselves. The key is effective disclosure.

International integration

Impediments to financial integration

Removing impediments will assist the flow of benefits from integration, especially by addressing ownership restrictions and increasing mutual recognition.

Cross border regulatory settings

Mutual recognition appears to offer a path to navigating cross border regulatory settings, subject to balancing the rule of law, regulation and supervision.

Part II

Detailed Recommendations

4 Competition

4.1 Banking

4.1.1 Regulatory capital requirements

The Interim Report notes that banks that use internal ratings-based (IRB) risk weights have lower risk weights for mortgage lending than authorised deposit-taking institutions (ADIs) that use standardised risk weights. This gives IRB banks a cost advantage over standardised ADIs.

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

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

The Inquiry seeks further information on the following area:

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

Deloitte comments:

Global regulations recognise both IRB risk weights and standardised risk weights. IRB risk weights are a more efficient mechanism for allocating capital as they account for the idiosyncratic risk of an ADI's loan portfolio. By contrast, standardised risk weights are by nature 'one-size fits all'. Lowering standardised risk weights either for mortgages or through the introduction of a tiered system would still result in risk weights that do not account for the idiosyncratic risks in a portfolio. Hence, policy options that move ADIs from standardised risk weights towards IRB risk weights are preferred from competition and efficiency viewpoints.

Assisting smaller ADIs attain IRB accreditation would result in a more efficient capital allocation and improved consumer outcomes. While IRB accreditation is intended for managing the entire loan book, given that the loan book for most smaller ADIs is predominantly comprised of mortgage loans, allowing smaller ADIs to adopt IRB modelling for mortgages only is likely to contribute to more efficient capital allocation and improved consumer outcomes.

The Inquiry could consider allowing smaller ADIs to outsource their risk modelling, or use a standardised IRB model. For example, a provider gets an IRB model approved by APRA. It then provides that model to smaller ADIs who can enter institution-specific parameters and obtain risk weights that are acceptable for use by APRA. This would provide a way of giving ADIs access to somewhat idiosyncratic risk weights without them having to build an internal modelling team and framework, providing a half-way house between standardised risk weights and full-IRB accreditation.

Do not raise minimum IRB risk weights; instead, support ADIs to move towards IRB risk weights..

4.1.2 Funding costs

APRA's treatment of residential mortgage-backed securities (RMBS) differs from other jurisdictions, disproportionately affecting smaller ADIs who rely more on RMBS markets for funding, and with knock-on effects for non-bank lenders who also use RMBS markets.

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

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

Deloitte comments:

RMBS has been a cost-effective source of funds for smaller ADIs and non-bank lenders. More broadly, securitisation also provides a means to transfer risk, particularly residential property risk, to investors outside the banking system. A robust RMBS market provides benefits to competition and risk management.

Legitimate concerns about the liquidity of RMBS in times of market stress remain, as they do for all non-government debt securities. As a result, the RMBS market has not returned to pre-GFC levels. While domestic investors' appetite for RMBS has returned, global investors largely have not returned.

Importantly, APRA's treatment of RMBS is not consistent with practices in other jurisdictions. This was detailed in the Australia Securitisation Forum's submission to the Inquiry.[10] For example, in its proposed rules regarding master trust structures and recognition of RMBS as high quality liquid assets (HQLAs), APRA has adopted a different approach.

A larger securitisation market requires liquidity, global investors and a supportive and predictable regulatory framework.

- **Liquidity** in the secondary market could be bolstered by improved post-trade reporting of prices. This could potentially be done via any entity that has oversight of trading – e.g. bond payments go through Austraclear so they should know when a

[10] Australian Securitisation Forum (2014) *Submission to the Australian Government's Financial System Inquiry 2014*, http://fsi.gov.au/files/2014/04/Australian_Securitisation_Forum.pdf

trade has occurred and therefore could be a reliable gatherer of such information. However, this would require the buyer/seller to divulge a price.

- The growing superannuation pool may boost domestic demand for RMBS over time. Amendments to the regulatory framework to bring Australia more in line with global standards is likely to assist getting mandates changed to accommodate RMBS.

With no change in policy, **global investors** are likely to be slow to re-engage. Flexibility as to issuance possibilities would enable the marketing of mortgaged-backed transactions to investors with a wider mandate. Currently the swap costs inherent in the pass-through structures which dominate Australian issuance limit the demand from overseas. Master trust structures enabling bullet repayment profiles and date based calls would increase certainty for investors, thereby reducing hurdles to investment.

A supportive **regulatory framework** is also important to the development of a liquid RMBS market. Eligibility of RMBS for the RBA's committed liquidity facility (CLF) increases liquidity in the overall financial system, especially for those ADIs who are significant investors in RMBS (or ABS), and particularly during periods of distress when only government debt remains liquid. In regulatory frameworks in other jurisdictions, such as the UK and Europe, RMBS which are eligible for central bank liquidity support are also recognised as eligible for HQLA status.

We endorse the ASF's views that enabling master trust structures and recognising RMBS as HQLA are steps along the path to delivering a more active securitisation market; nudging it forward rather than directly intervening is a preferred option.

We would recommend pursuing measures that would encourage improved liquidity in the RMBS market. This could be achieved by reviewing regulatory impediments to RMBS being treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio.

4.1.3 The concentration and integration of the major banks

Integration in banking may diminish consumer outcomes if banks can take advantage of their market power.

The Inquiry seeks further information on the following areas:

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

Deloitte comments:

Deloitte believes the retail banking sector is competitive as outlined in Section 1.3.1. Based on the measure preferred by the Australian Competition and Consumer Commission (ACCC), the Herfindahl-Hirschman Index (HHI), the main retail banking product markets in

Australia are below the threshold level of 2000 that would signal further investigation is warranted.[11]

The **major banks have integrated** horizontally into sectors such as wealth management and insurance. We agree with the Inquiry's assessment that it is not clear this has led to an abuse of power. There also are benefits from horizontal integration that improve consumer outcomes. Integration allows banks to offer bundles of complimentary products. This can improve consumer outcomes by decreasing consumer search costs (i.e. providing convenience) and reducing product costs (e.g. by reducing marketing costs).

Vertical integration is a concern if the absence of competition upstream allows banks to raise their competitors' costs of entering downstream markets. As noted above, the upstream market – retail banking – in Australia is competitive. Downstream, barriers to entry to mortgage broking are low and technology enables competition at various points along the value change.

Vertical integration can improve consumer outcomes by reducing costs, through removing information asymmetries and systems duplication between different stages of the value chain.

In the mortgage broking market positive network effects provide banks with incentives to include competitors' products in their broker networks. Larger networks lead to more banks per broker, resulting in enhanced consumer choice and lower costs. For example, ANZ does not own a broker group, but uses broker groups extensively; this suggests banks do not use vertical integration to exclude competitors.

If there are concerns about the way mortgage brokers direct borrowers to lenders, these are best dealt with by options outlined in the Consumer Outcomes section of the Interim Report.

Increased (vertical) integration in banking has been driven by consumer preferences and needs and, in general, is not causing competition issues or distorting the way in which mortgage brokers direct borrowers to lenders.

4.1.4 Lenders mortgage insurance

APRA's stance on capital requirements for ADIs discourages the use of lenders mortgage insurance (LMI) for risk mitigation.

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

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

[11] Deloitte Access Economics (2014) *Competition in retail banking* http://fsi.gov.au/files/2014/04/ABA_2.pdf

Deloitte comments:

Global regulators recommend the use of LMI to reduce the credit risk for high LVR mortgages.

"MI provides additional financing flexibility for lenders and consumers, and supervisors should consider how to use such coverage effectively in conjunction with LTV requirements to meet housing goals and needs in their respective markets. Supervisors should explore both public and private options (including creditworthiness and reserve requirements), and ***should take steps to require adequate MI in instances of high LTV lending*** *(e.g. greater than 80% LTV)" (Joint Forum 2010, emphasis added).*[12]

However, APRA has departed from the global standard for calculating ADIs' capital requirements (a 10% LGD floor), setting a more onerous requirement, and this has affected usage of LMI in Australia.

"For ADIs using approved internal models under Basel II, ***APRAs requirement for a 20 per cent loss given default (LGD) floor has, to a significant extent, reduced the explicit regulatory incentive for ADIs to seek LMI cover****. Nevertheless, such ADIs still see the benefit of LMI as a risk transfer mechanism and thus continue to buy LMI protection for their high LTV loans" (Joint Forum 2010, emphasis added).*[13]

Of the main individual country LMI markets, Australia stands out because it does not provide capital relief for LMI for IRB banks. All the other countries provide capital relief, except Hong Kong where LMI is compulsory for LTVs greater than 70%.[14]

If APRA has concerns about LMI's capital adequacy, this should be addressed directly, rather than through more onerous capital requirements for banks. The imposition of a higher LGD floor in Australia also adversely affects the stability, competition and equity benefits that LMI provides to the Australian economy. These points are also outlined in Deloitte Access Economics' report that is part of Genworth's response to the Interim Report.[15]

If decreasing IRB risk weights for insured loans increases the large banks' cost advantage, this should be addressed by assisting smaller lenders as noted in Section 4.1.1. Moreover, as smaller lenders are more dependent on LMI than large lenders, there are competition benefits from having a sustainable LMI market.

While global standards have not yet been formalised, aligning the LGD floor for insured loans would improve economic outcomes.

[12] Basel Committee on Banking Supervision Joint Forum (2013) *Mortgage insurance: market structure, underwriting cycle and policy implications*, http://www.bis.org/publ/joint30.pdf

[13] Ibid.

[14] Ibid. The countries are Australia, Canada, France, Germany, Hong Kong, Netherlands, United Kingdom, United States

[15] Genworth (2014, to be released) *Response to the Interim Report of the Financial System Inquiry*.

4.2 Payments sector

Payments systems that perform similar functions are being regulated differently.

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

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

Deloitte comments:

The current regulation of **interchange fees** has not led to a demonstrable increase in payment system efficiency or significant benefits to consumers. Merchant service fees have fallen as competition between acquirers has reduced interchange fees passed through. This has been paid for by card users who receive lower benefits for the same value of transactions. Any optimal setting of the interchange fee must balance distributing benefits between cardholders and merchants in a way that drives efficient adoption and use of payment instruments. It is not clear that the current regulations, which are based on a relatively arbitrary choice of interchange fee cap, have led to a better outcome.[16]

Payment systems are complicated markets and the theoretical understanding of their key features, and policy implications, has developed slowly recently. This has highlighted the role that interchange fees play in driving innovation and product adoption in payment markets, due to the strong network effects at play. Removing interchange fees will harm the development of these products and reduce future innovation.

A particular consequence of regulating interchange fees for four-party credit card schemes has been to increase the market share of competing schemes that are not regulated. In particular, the companion cards offered by existing three party schemes and issued by banks mimic the structure of four party schemes, but are not subject to regulation. This is despite the 'issuer fees' driving the payment of rewards playing the same role of an interchange fee, in the existing four-party schemes.

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[16] Deloitte Access Economics (2014) *Competitive neutrality in Australian payments markets* http://fsi.gov.au/files/2014/04/VISA_part_2.pdf

The market share of three party schemes has risen significantly since the implementation of interchange fee regulation. Changes in market share per se are not a problem and are expected in rapidly changing markets, but given they are largely due to unequal regulation of essentially identical payments instruments, they are likely to result in inefficiencies.

This is exacerbated by three-party scheme products being increasingly used for transactions that were traditionally the domain of four-party cards. For example, over half of all three-party card transactions now occur at supermarkets or petrol stations. Looking forward, additional products may enter the market in direct competition with the regulated four-party schemes, but not be subject to fee regulation. Deloitte understands there are plans for new four-party schemes (such as China UnionPay) to launch products that would compete directly with the existing regulated schemes, but not be subject to fee regulation.

Given the uncertainty around what would constitute an 'optimal' interchange fee, and the outcome of the current regulatory setting leading to competitive non-neutrality, Deloitte supports removing interchange fee caps. This would eliminate the regulatory arbitrage currently driving payment outcomes. Ongoing monitoring and benchmarking by the Payment System Board would provide an appropriate level of oversight to ensure effective competition continues to evolve between competing products.

The removal of **no-surcharge rules** has led to some adverse consumer outcomes in some situations. The regulations allowing surcharging intended to allow merchants to pass on the costs associated with a customer's payment choice. In large part, this would reflect the merchant service fee charged by the acquirer when a credit card is used, in turn reflecting the size of the interchange fee the acquirer is charged.

However, the size of surcharges in some retail segments have been well in excess of any reasonable costs the merchant could seek to pass on. This has been most prevalent for online purchases, including relating to the airline and ticketing industries. Allowing merchants to over-recover costs through not limiting the size of surcharging reduces the effectiveness of price signals in payment systems.

Although card schemes have been allowed to place some limits on the surcharges imposed by merchants under changes introduced in March 2013, this has some practical difficulties. In particular, card schemes have no direct relationship with merchants and can only act through their acquirer clients to implement this supervisory role. A preferred approach would be for an existing statutory body to enforce surcharging limits commensurate with this guidance. Such an approach would increase the authority and transparency of rules to limit excessive surcharging and is more in line with existing regulation of price controls.

The current non-neutrality in the treatment of companion cards causes market distortions. Formal interchange fee regulation is inappropriate and should be removed. Monitoring and benchmarking should be used instead. Surcharging regulations are focused on consumer protection rather than competition issues. Any surcharging regulations should be policed by regulators in targeted sectors as necessary.

5 Funding

5.1 Housing and household leverage

The Interim Report has noted that housing accounts for a large share of banks' and households' balance sheets.

> **The Inquiry seeks further information on the following area:**
>
> What measures can be taken to mitigate the effects of developments in the housing market on the financial system and the economy? How might these measures be implemented and what practical issues would need to be considered?

Deloitte comments:

The Inquiry's information request above suggests that Australia's exposure to housing is a problem. However, to the extent that there is a tilt towards housing it will reflect households' natural response to incentives embedded in the taxation and social security systems.

So it is not clear that there is a financial system issue. If policy makers have decided that steering more resources towards housing is a desirable outcome, then financial sector regulation should not necessarily be set to oppose that outcome.

It also is not clear that households have too much debt; while debt levels have increased, they have stabilised and it is not clear what an optimal level should be. Current household debt levels are a reflection of improved access to credit for many Australians; this has improved consumer outcomes in terms of efficiency and equity.

Another issue raised is whether house prices are too high. Unless accompanied by excessive borrowing, this is a supply issue that can only be addressed outside financial regulation. Otherwise, monetary policy has proved effective in easing pressure in the past. This is backed up by maintaining good lending standards and effective APRA supervision. The impact of housing risk on the banking sector and systemic stability can also be mitigated by transferring it outside the banking sector; e.g. by insuring loans or through securitisation.

> **Action by financial sector regulators to mitigate the effects of developments in the housing market on the financial system and the economy should be limited to monetary policy and the occasional use of supervisory action by APRA.**

5.2 Small- and medium-sized enterprises

The Interim Report has noted that information asymmetries can adversely impact the cost and availability of credit for small- and medium-sized enterprises (SMEs).

The Inquiry seeks further information on the following areas:

- To what degree will technological developments resolve issues related to information asymmetries in SME lending?
- What are the best options to narrow the informational gaps between lenders and SME borrowers?
- Could the use of certain loan covenants be reduced, while still providing SMEs with adequate access to finance and lenders with appropriate protection?
- What are the prospects for a market for securitised SME loans developing?
- What are the main barriers to greater broker activity in SME finance? Are these barriers transitional or structural in nature?
- What are the best options for improving the tax treatment of VCLPs?

Deloitte comments:

The challenges to SME funding were noted by the Wallis Inquiry in 1997 and the Campbell Inquiry before that in 1979. This indicates that although Australian governments have long felt the need to improve access to capital for SMEs, it is an especially challenging problem for policy makers.

The Inquiry notes that SMEs are restricted by information asymmetries, regulation and taxation. A full assessment of these impediments and potential solutions was included in Deloitte Access Economics' report for the NSW Business Chamber's submission to the Inquiry.[17]

Cost-effective **technological developments** could improve access to capital by addressing the information asymmetry directly. For lenders, comprehensive credit reporting has the potential to improve information on potential borrowers, e.g. where the borrower's residence is used for security. Dynamic credit reporting may also help. However, given the slow take up of lenders to the comprehensive credit reporting regime for retail borrowers, who tend to have easily comparable credit data points, the benefits from these changes may not impact the cost and availability of SME funding immediately.

Changes in accounting technology may provide technology suppliers and others with access to data that could be used to drive credit decisions. For example, the availability of information about clients' cash flows and assets, in real time, could enable that data to be used to make credit decisions.

[17] Deloitte Access Economics (2013) *Access to capital for small- and medium-sized enterprises* http://fsi.gov.au/files/2014/04/NSW_Business_Chamber_Attachment_A.pdf

Technology also can assist with reducing search times for securing funds and the cost of getting expert advice. This could be facilitated by standardising loan application criteria across types of funding, and across banks to some extent, to reduce the application costs to SMEs. However, this option is limited because banks have different business models and offer credit to a wide range of businesses.

Financial education will continue to play a positive role in addressing **information gaps**, subject to the behavioural limits noted earlier. For example, improved financial literacy would enable borrowers to improve their ability to provide information to a financial institution in a manner that satisfies the institution's minimum information requirements.

Securitisation of SME loans could also improve access to credit for SME's, with the added attraction of moving some of the risk off banks' balance sheets. However, it is likely banks would need to take a junior tranche in any securitisation of SME loans – i.e. the first level of credit risk – which would then also preclude capital relief.

SME securitisation has the support of institutions both in Australia and globally, however, the reality is that there has been very little securitisation of SME debt since the GFC. This should not be construed as meaning that the Australian banks are not extending credit to SME borrowers, or that the capital market has no appetite for risk exposure to SMEs; the limited ABS transactions that have been successful in the post GFC environment (e.g. $5bn Australian ABS were issued in 2013) are fundamentally SME transactions, secured on underlying collateral used in the business, rather than on property.

In time, more assets will be required by **superannuation funds**. However, the credit skills required to assess SME loans currently reside with banks. This suggests the role of developing suitable products for investors that traditionally was undertaken by corporate and investment banks will remain important.

> **Basic information asymmetries have persisted over time. It is possible that technological solutions can help reduce this, but there is not yet a strong evidence base for how cost-effective regulatory change could accelerate this.**

5.3 Superannuation

The Interim Report notes that the growth of superannuation will be important in funding economic activity in Australia.

> **The Inquiry seeks further information on the following area:**
>
> What effects will the trends in the size and composition of superannuation have on the broader flow of funds in the economy over the next few decades, including on international capital flows to and from Australia?

Deloitte comments:

Deloitte has projected that by 2033 superannuation assets will grow from $1.8 trillion to $7.6 trillion. [18]

The growth in the share of financial system assets held by superannuation funds has the potential to impact activity in one of the key roles of the financial system, viz. matching savings with investment needs throughout the economy. If superannuation funds developed or acquired the requisite credit assessment capabilities, then they would be able to fund lending activity in **competition with the banks**. This could result in banks increasing their focus on transactions and product origination, and reducing the extent to which they act as the underlying funder of assets.

If superannuation funds do not undertake maturity transformation and are not leveraged, this development should increase financial stability.

The growth of superannuation funds will increase **demand for domestic securities**. This demand will be constrained by the supply of suitable securities and concentration risk. Superannuation can undertake more lending to sectors where there is unmet demand for funds, e.g. SMEs or for infrastructure, provided suitable products become available. For example, superannuation funds would be able to take control over longer-term infrastructure finance (e.g. for a 25-year period) if banks provide bridge finance for a transition period of, e.g. three to five years.

However, APRA's requirements for high levels of liquid assets in reserve are a disincentive for superannuation funds to invest in long-term and illiquid assets, which might drive investment to shorter-term and more liquid offshore assets.

Currently, although superannuation invests a the majority of its assets in local equity (70% of equity assets are invested in domestic corporates) and debt markets (85%), and already exhibits a strong domestic bias compared, for instance to an allocation based on the size of domestic equity and fixed income markets, it does invest a significant proportion of its assets offshore (18% in 2013, down from a peak of 24% in the early 2000s).[19] This share is expected to grow over time as superannuation funds, due to limited domestic opportunities, look overseas to find investment opportunities that maximise returns.[20]

Superannuation funds will invest **more funds offshore** too, to obtain necessary diversification and exposure to growth opportunities in dynamic economies around the world. This both reduces home country bias and concentration risk.

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[18] Deloitte (2013) *Dynamics of the Australian Superannuation System*. http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Deloitte_Dynamics_of_Superannuation_2013_report.pdf

[19] Deloitte Access Economics (2013) *Maximising superannuation capital*, report prepared for the Association of Superannuation Funds of Australia.

[20] Ibid. The implications of the increase in superannuation for national saving and the balance of payments is not clear cut; it depends on the interactions of saving by households, government and business, and investors in the economy. The impact of increasing superannuation assets offshore will be influenced by the relative rates of return on Australian investment abroad and foreign investment in Australia.

Although historically SMSFs have had very low exposure to international equity, this sector is likely to increase its exposure to international equities, particularly through investments in managed funds. The Australian funds management industry may need to use more offshore managers to facilitate increased investment flows. Such offshore investments can provide significant benefits to the Australian economy as they not only increase returns, but also help with diversification and risk mitigation. For example, during the GFC, repatriated money from superannuation funds provided a key source of capital to Australian companies, at a time when other capital sources dried up, and thereby supported financial stability.[21]

The growth in superannuation could result in superannuation funds funding an increased proportion of economic activity in Australia.

While the proportion of superannuation funds assets devoted to fixed income will increase, their investments in equities and alternatives will rise as a share of GDP.

5.4 The corporate bond market

The Interim report notes that while corporate bond issuance has increased, the Australian corporate bond market is underdeveloped.

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

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

The Inquiry seeks further information on the following areas:

- As a greater share of the population enters retirement, would the demand for fixed income products increase in the absence of regulation or other incentives?
- Would the development of annuity-style retirement income investment products encourage the growth of fixed income markets?

[21] Ibid.

Deloitte comments:

There are a variety of reasons why Australian companies prefer borrowing from banks over issuing debt securities. A key difference is the convenience of a line of credit with a bank compared to the time taken to raise debt in the capital market. In time there may be a technical solution to this obstacle, but in the meantime initiatives to address impediments to issuing should be pursued.

Deloitte supports allowing listed issuers which are subject to continuous disclosure to **issue vanilla bonds to retail investors**. This already occurs in other jurisdictions and is likely to help the development of the domestic corporate bond market at the margin. To help facilitate this, there should be a reassessment of the current regulatory impasse that prevents credit ratings being provided to retail investors.

On average, **people entering retirement** can expect to have 20 or more years of life ahead of them. This is a long enough period for those prepared to hold risky assets pre-retirement to continue to do so post-retirement. As they get older and their planning time horizon shortens then they would rationally reduce risk. This could increase demand for fixed income products, preferably fixed in real terms rather than nominal terms to avoid exposure to inflation risk.

Annuity-style products carry high capital requirements. One way to reduce capital requirements is to buy assets that match the annuities with high quality, fixed interest assets of durations that last as long as the annuities, i.e. a long time. Annuity providers in the United Kingdom (UK) invest a high proportion of assets in fixed interest securities. If Australia developed an annuity market as substantial as the UK's then it is reasonable to expect a similar, high demand for fixed interest assets.

Allowing listed issuers to issue vanilla bonds directly to retail investors would help the corporate bond market at the margin.

The growth in the number of older retirees is likely to result in an increase in demand for fixed income products and annuity–style products without requiring any additional incentives or regulatory changes. This demographic change will support the growth of fixed income markets.

6 Superannuation

6.1 Efficiency

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

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

The Inquiry seeks further information on the following areas:

- Does, or will, MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns? What are the costs and benefits of auctioning the management rights to default funds principally on the basis of fees for a given asset mix? Are there alternative options?
- Is the recent trend of greater vertical integration in the wealth management and superannuation sectors reducing competitive pressures and contributing to higher superannuation fees? Are there mechanisms to ensure the efficiency of vertical integration flow through to consumers?
- Are there net benefits in tailoring asset allocation to members and/or projecting retirement incomes on superannuation statements?
- Is there an undue focus on short-term returns by superannuation funds? If this is a significant issue, how might it be addressed?
- To what extent is there a trend away from active asset management within asset classes in superannuation funds? Is this a positive or negative development for members?
- How could funds price switching properly and take into account differences in liquidity between asset classes?
- Could other arrangements be developed to facilitate asset transfers between funds when members switch? Do funds require additional mechanisms to manage liquidity beyond the need for liquidity for portability and member investment switching?
- Is the trust structure best placed to meet the needs of members in a cost-effective manner?

Deloitte comments:

With superannuation growing as a share of the economy, it is increasingly important to ensure it is cost effective.

The financial sector is accounting for a growing share of the economy. In superannuation, assets are estimated to reach 180% of GDP by 2033.[22] Even if fees are only 1% of funds under management, they will amount to 1.8% of GDP. Reducing fees by 40 basis points would represent significant microeconomic reform.

Costs differ at points along the wealth management value chain (Figure 6.1). At around 5 basis points or less, the costs of administration and gatekeepers respectively are a relatively small share of the total costs. The largest costs are for asset management and distribution. This suggests that the greatest scope for cost reduction is at these stages of the value chain.

Figure 6.1: Wealth management value chain

Source: Deloitte Access Economics

However it is important to consider benefits as well as costs in considering how value is delivered across the wealth management value chain. The asset management and distribution stages deliver valuable benefits to consumers including higher returns and financial advice (see Chapter 8 for a discussion of advice). The key challenge is not to compromise any of those benefits in the effort to remove costs.

Comparisons with overseas funds are challenging due to the myriad differences in pension schemes and systems across countries. Factors that add to costs of Australian pension (superannuation) schemes include:

- a greater proportion of funds management is undertaken within superannuation funds compared to some overseas funds, with the costs of this activity therefore recorded directly rather than being netted against investment returns;
- APRA-regulated funds have a greater share of more actively managed assets;
- there is more choice and flexibility at the individual level; and
- reporting and compliance requirements of superannuation tend to be greater in Australia – for example AFS Licencing, Stronger Super, MySuper and Choice of Funds – and add to costs.[23]

These factors bring additional benefits, but obfuscate attempts at direct comparisons of costs.

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[22] Deloitte (2013) *Dynamics of the Australian Superannuation System*. http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Deloitte_Dynamics_of_Superannuation_2013_report.pdf

[23] Deloitte (2014) *A comparison of financial advice regulations – personal advice for retail clients* http://www.fsc.org.au/downloads/file/SubmissionsFile/FSCFOFAsupplementary.pdf

Most in the industry want members to concentrate on net investment returns after fees and expenses. This is because higher returns are associated with investments in higher-fee asset classes such as direct property, infrastructure, hedge funds and private equity. There has been competition in the superannuation sector on the subject of fees as evidenced by the industry funds "Compare the Pair" advertising campaign. While this was largely based around commission it still looked at the total costs to members.

MySuper reforms are intended to present a low-cost default option which new employees may opt-out of. Stringent disclosure and cost requirements suggest that these are likely to be easier for consumers to understand as well as offering lower fees. MySuper has not been in place long enough for its effectiveness to be properly assessed. One issue will be the comparison of MySuper products: approximately 90% of industry funds adopt a balanced approach as their MySuper option, whereas a little over 50% of retail funds have adopted a life-cycle option. Even within the life-cycle options there is a wide variation in asset allocation which makes comparisons difficult.

Additional mechanisms in MySuper that could be considered include:

- long-term disability income insurance; and
- longevity insurance.

Long-term disability income insurance as an alternative to lump sum total and permanent disablement insurance would provide members of superannuation funds, especially younger members with a valuable benefit should they become disabled. Longevity insurance, in the form of a deferred annuity, also could be included. Enabling employees to begin contributions to a deferred annuity in their 20s or 30s would help overcome the adverse selection problems associated with annuities purchased much later in life.

Liquidity requirements are intended to support **portability** and therefore competition. However, they do not lend themselves well to the general nature of superannuation which is long-term investment for retirement. On the one hand, reducing switching costs contributes to stronger competition. However, portability can bias superannuation funds' investment strategies and contribute to a higher allocation to liquid assets; this can result in lower long-term returns for consumers. Linking the time period for portability to the liquidity of the underlying assets could potentially reduce the current bias to more liquid investments. Funds could be legally required to transfer funds 'within a time frame which is reasonable under the circumstances'. For example, cash could have a three-day rule, but a pure direct property option might be as long as 12 months depending upon the redemption provisions of the contract and the overall liquidity of the market.

MySuper is consistent with generating a more cost effective solution for people, with costs and benefits commensurate with value. However, MySuper is the default option within a broader range of investment and insurance options. The broader **competitive pressures** will come from the full range of member and employer services provided and the net of fees investment returns to members.

Auctioning the management/administration of MySuper options would be impractical (as they are embedded within existing funds) and runs the risk of an overly concentrated market if the unsuccessful organisations withdraw from the Australian market. Competition will reduce with no guarantee that fees, in the longer term, will be lower.

Vertical integration does not mean that there will be less competition. It may encourage lower prices and stronger competition down-stream, as cost savings can be passed on. Negative competition effects are more likely to result where the upstream supplier has significant market power and can restrict supply/raise prices.[24] A study by Arnhem uses the ACCC's preferred measure, a HHI, to analyse the concentration of the industry.[25] It concludes that the wealth management industry is highly fragmented, suggesting intense competition. While there is a large degree of vertical integration, this does not appear to be reducing competition and leading to higher fees.[26]

Tailoring asset allocation is a fundamental question of the trade-off between costs and benefits. More tailored products are generally more expensive. However, ceteris paribus, they are also more 'fit for purpose' and better suited to individual needs, both at a point in time and over time. There is evidence of significant heterogeneity which could affect long-term payoffs as risk aversion varies with age, gender, marital status and parental education.[27] Portfolio theory suggests that asset allocations should be matched to individual risk preferences. The current system allows individuals to make such decisions from complete personal tailoring (SMSFs) to generic products (e.g. defaults, index funds).

In **Australia there is no clear trend away from active asset management** unlike the rest of the world. Globally, the number of equities index funds has increased from a share of total assets of just less than 10% in 2007 to just less than 20% in 2013, except in Australia and New Zealand (Oceania), where there was a small outflow from index funds in 2012. Compared with other world regions, Oceania's 8% of managed fund assets invested in index strategies also has less money passively managed. At 31 December 2012, in Asia, 22% of managed fund assets were in index strategies, and in the USA, 24%.[28] However, MySuper may simplify asset allocations by encouraging passive/index style investment allocation.

It is important that the Inquiry focus on both benefits and costs when assessing the efficiency of the superannuation sector. A focus on fees and costs, without adequate consideration of benefits raises the risk that proposed policy interventions may result in adverse consumer outcomes. It is important to allow time to determine the outcomes of the recent MySuper super reforms before proposing additional changes..

[24] Meyer CS and Wang Y (2011) *Detecting the competitive effects of vertical integration in mergers* http://www.nera.com/nera-files/PUB_Vertical_Integration_0511.pdf
[25] Arnhem (2012) *Too much of a good thing: The future of the Australian wealth management industry.* http://www.arnhem.com.au/wp-content/uploads/2014/03/Arnhem_TheFutureoftheAustralianWealthManagementIndustry.pdf
[26] Parliamentary Joint Committee on Corporations and Financial Services (2009) *Inquiry into financial products and services in Australia*. http://www.aph.gov.au/binaries/senate/committee/corporations_ctte/fps/report/report.pdf
[27] Dohmen T et al (2009) *Individual Risk Attitudes: Measurement, Determinants and Behavioural Consequences* http://www.researchgate.net/publication/227348767_INDIVIDUAL_RISK_ATTITUDES_MEASUREMENT_DETERMINANTS_AND_BEHAVIORAL_CONSEQUENCES/file/d912f50997dce54f06.pdf
[28] Purnell (2013) *Australia defying global index funds trend – for now*. http://www.moneymanagement.com.au/analysis/investment/2013/australia-defying-global-index-funds-trend-for-now

6.2 Leverage

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

Restore the general prohibition on direct leverage of superannuation funds on a prospective basis

Deloitte comments:

The primary objective of superannuation is saving for retirement. APRA-regulated superannuation funds are unleveraged. Allowing SMSFs to use direct leverage creates competitive non-neutrality in the system.

A general prohibition of direct leverage on superannuation funds would still allow individuals to use leverage on their personal, non-compulsory, and non-tax-advantaged savings. For such a prohibition to be effective, products which are economically equivalent to gearing should be monitored in this context.

Restoration of the general prohibition on direct leverage of superannuation funds improves competitive neutrality and limits the tax advantages of superannuation to funds that have been saved and not borrowed.

6.3 Self-managed superannuation funds

The Interim Report notes that self-managed superannuation funds with low balances are relatively more expensive to run.

The Inquiry seeks further information on the following areas:

- To what extent should the Inquiry be concerned about the high operating expenses of many SMSFs?
- Should there be any limitations on the establishment of SMSFs?

Deloitte comments:

An emphasis on the costs of SMSF risks overlooking the benefits to members. There is some ambiguity around the definition of ‘high’ expenses in the Interim Report. Moreover, ‘high’ expenses may be compensated for by high benefits.

Typically, **SMSF expenses** and returns are expressed in ’gross’ terms whereas APRA-regulated funds report expenses in ‘net’ terms. Consider an SMSF generating a $50,000 (gross) return with $3,000 (gross) expenses and a platform providing a $47,000 (net) return with zero expenses. In this case, a comparison of expenses can be misleading.

ASIC report CP216 unbundles SMSFs expenses to allow comparison with APRA-supervised funds.[29] The paper shows that as SMSFs balances grow, expenses increasingly are cost neutral or have a cost advantage. Expenses need to judged in light of benefits received, including advice, which is considered in Chapter 8.

There currently are **limitations on SMSFs** with respect to who can qualify as a trustee and as a member; and what investments are prohibited or conditional. However, despite concerns about high fixed costs relative to balances for smaller SMSFs we don't think there should be limitations on the minimum balance for setting up an SMSF (the real issue is the appropriateness of the recommendation by advisers for consumers with lower asset levels to use a SMSF).

At set up, accounts will have a zero balance by definition. Set up also requires establishing a bank account; making the SMSF a complying fund, including paying administration and regulatory costs. At this point, members can make contributions of varying size and frequency or roll over funds into the SMSF. More than one member can make contributions or roll-over funds into the SMSF. The range of possible permutations in how fast an SMSF's balance can grow suggests it is impractical to specify a limitation up front.

> **The Inquiry should not be directly concerned about these high operating expenses per se; rather, it should take in to account the quality of advice SMSFs are receiving.**
>
> **There are practical difficulties on imposing limitations on the establishment of SMSFs.**

[29] Australian Securities & Investments Commission (2013) *Advice on self-manage super funds: Specific disclosure requirements and SMSF costs* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp216-published-16-September-2013.pdf/$file/cp216-published-16-September-2013.pdf

7 Stability

7.1 Too-big-to-fail and moral hazard

7.1.1 Recovery and resolution preparedness

7.1.1.1 Imposing losses on creditors

The Interim Report notes that introducing credible ways to impose losses on creditors in the event of failure assists in achieving orderly resolution.

> **The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:**
>
> • No change to current arrangements.
> • Increase the ability to impose losses on creditors of a financial institution in the event of its failure.

Deloitte comments:

Recovery and resolution preparedness is seen as essential to achieving orderly resolution, and getting creditors to bear losses in the event of failure, as they should, rather than taxpayers.

There are a number of existing types of 'creditors' potentially facing losses when a SIFI fails, including holders of bail-in debt, investors in covered bonds, deposit insurers and holders of equity. Existing inter-bank exposures are such that Australian banks have a significant exposure to each other's balance sheets.

As the Inquiry has noted, some Australian banks have already issued bail-in debt, which now qualifies as Tier 2 capital under the Basel III framework. This kind of debt expands a firm's gone concern loss absorbing capacity (GLAC) and thus protects unsecured creditors, and implicitly taxpayers, from suffering losses in the event of a negative shock to a financial institution's balance sheet.

In the UK, the resolution and bail-in regime and ring-fencing are intended to support SIFIs and smooth the GLAC of creditors. Moody's downgraded the credit outlook for UK banks due to the decreased likelihood that banks would receive a public bail-out in the future.[30]

Rule-based bail-in triggers are not preferred. It would be difficult to design a rule that would be sufficiently robust to cover all circumstances. There is a risk that a rule-based bail-in trigger could unnecessarily bail-in creditors, or be applied in a way that did not adequately take into account how much capital needed to be injected and on what terms, given a bank's individual position.

[30] Treanor, J. (2014) *Moody's downgrades outlook for UK banking sector to negative*. http://www.theguardian.com/business/2014/aug/05/moodys-downgrades-outlook-uk-banking-sector-negative

The proposal in November from the G20 will likely involve **a prohibition on banks owning other banks wholesale debt**. This creates a whole other set of issues; the imposition of losses on creditors is problematic if the creditors in question are other vulnerable financial institutions. This follows from the observation that contagion can still be propagated through bail-in debt.

In extreme circumstances, and as the Interim Report notes, there is a difficult trade-off to be made between imposing losses on specific creditors and contagion risk. As this trade-off is part of ongoing consideration by the FSB and the G-20, Australia should consider the result of these deliberations before finalising its own response.

Increasing the ability of regulators to impose losses on creditors will be difficult to effectively put into practice. As a result we would support no changes to current arrangements.

7.1.1.2 Resolution powers, pre-planning and pre-positioning

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

- No change to current arrangements
- Strengthen regulators' resolution powers for financial institutions.
- Invest more in pre-planning and pre-positioning for financial failure.

Deloitte comments:

Recovery and resolution plans are an important component in reducing perceptions that some institutions are too-big-to-fail. We endorse the Inquiry's comment in the Interim Report that there is value in an internationally consistent approach to promote a level playing field globally.

The global regulatory framework now requires SIFIs to have resolution and recovery plans in place by 2015. Ahead of this, regulators are working with SIFIs and requesting changes be made to plans. Continuing the existing process to align APRA's resolution powers with international standards promotes a more consistent international approach.

The global framework is still being implemented and this process should be allowed to run its course. It is important for APRA to continue to engage with banks on these plans.

APRA should continue to engage with banks as it aligns Australia's recovery and resolution processes with international standards.

The global framework has been established, and should be allowed to run its course.

7.1.2 Capital requirements

Increased capital requirements for SIFIs has been a key part of the international response to the GFC.

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

- No change to current arrangements.
- Further increase capital requirements on financial institutions considered to be systemically important domestically.

Deloitte comments:

A key global response to the too-big-to-fail issue and moral hazard has been imposing additional capital requirements on SIFIs. This practice has been adopted in Australia and takes effect from 2016. Given that these changes are being implemented, we do not believe it is necessary to make further changes.

If international requirements change, this would be grounds for considering the costs and benefits of increasing capital requirements for Australian SIFIs. Given the economic opportunity cost associated with increased capital, any subsequent assessment of whether the capital requirements for domestic SIBs should be further increased would require a strong case as to why the existing levy is considered inadequate. Such an evaluation should consider that Australia's strong legal system and effective prudential oversight are arguments against the need for more onerous capital requirements.

The cost of increasing capital requirements on financial institutions is likely to be a sub-optimal capitalisation of banks, resulting in an increase in the cost of funding for banks. Rather than reducing risks to the system, this reduced profitability for banks could push marginal financial activity towards the regulatory perimeters, outside the scope of Australian regulators.

Australia already has increased capital requirements for domestic systemically important banks which is in accordance with global responses. No further changes to current arrangements should be considered at this stage.

7.1.3 The Financial Claims Scheme

The Interim Report notes that the threshold for Australia's deposit insurance scheme is high compared to most international schemes.

> **The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:**
>
> - No change to current arrangements.
> - Modify the FCS, possibly including simplification, lowering the insured threshold or introducing an ex ante fee.
>
> The Inquiry seeks further information on the following areas:
>
> - What measures could be taken to simplify the FCS with minimal burden on industry, while still ensuring the effectiveness of the scheme?
> - What is an appropriate threshold for the FCS guarantee of deposits?

Deloitte comments:

The costs associated with government-backed deposit insurance schemes were well known based on the Wallis Review. However the market wasn't behaving rationally during the GFC, so regulators moved away from Wallis to prevent panic and bank runs.

Australian depositors are already protected by depositor primacy, so the Financial Claims Scheme (FCS) effectively duplicated and extended the existing protection. Even with the advent of covered bonds, depositors still have first claim on 92% of a bank's assets. Moreover, the Interim Report describes the FCS as "generous" with a high threshold and almost universal coverage and notes that it distorts the allocation of capital.

Reducing the threshold for the FCS and introducing an ex-ante user pays principle for larger balances will reduce the inefficiencies created by the scheme in its current form. The policy goal is to prevent a run on banks, so the threshold should be set to achieve the objective based on average aggregate balances of a majority of depositors. If necessary, individuals with large balances could be provided with the option of insuring amounts above the threshold based on average aggregate balances.

> **The existing threshold for the FCS is too high and should be reduced.**

7.1.4 Ring fencing

The Interim report notes ring fencing protects systemically-important functions of financial institutions from other less important or riskier function.

> The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:
>
> • No change to current arrangements.
> • Ring-fence critical bank functions, such as retail activities.
>
> The Inquiry seeks further information on the following areas:
>
> • Is there a case for introducing ring-fencing in Australia now, or is there likely to be in the future?
> • If ring-fencing is pursued, what elements should be protected and from what risks? For example, should deposit-taking functions be protected from proprietary trading. Is one of the models used overseas appropriate for Australia?
> • How 'high' should any ring-fence be? Do ring-fenced activities need to occur in entirely separate financial institutions, or could they be part of a group structure that has other business activities? Within a group, what level of separation would be necessary?
> • Are there ways to achieve the same benefits as ring-fencing without the costs of structural separation?

Deloitte comments:

While a few jurisdictions have proposed ring-fencing reforms, there is no global agreement on the need for such reforms. Therefore Australia should be very cautious in considering proposing such reforms in the absence of any such global agreement. Ring-fencing imposes a significant efficiency cost, and as such is a measure that should not be taken lightly.

In Australia, the scale of proprietary trading activities at the domestic SIBs is relatively small compared to their retail banking activities. In addition, in addition to the costs associated with implementing ring-fencing, for any of the domestic SIBs, there are likely to be practical difficulties in making a clear distinction between proprietary trading and commercial banking activities. The recovery and resolution plans currently being implemented by 2015 may also strengthen the ability to separate specific financial activities, reducing the need to incur the expense of ring-fencing. If international requirements change, and global standards on ring-fencing were developed, this would be grounds for considering the costs and benefits of adopting ring-fencing requirements in Australia to strengthen global alignment.

> **There is currently no compelling reason to make changes to the current arrangements. Australia should continue to monitor global regulations on ring-fencing.**

7.2 Systemic risk

7.2.1 The prudential perimeter

The Interim Reports notes that systemic risks may emanate from outside the regulated core of the financial system.

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

- No change to current arrangements.
- Establish a mechanism, such as designation by the relevant Minister on advice from the RBA or CFR, to adjust the prudential perimeter to apply heightened regulatory and supervisory intensity to institutions or activities that pose systemic risks.

The Inquiry seeks further information on the following areas:

- Is new legislation the most appropriate mechanism to adjust the prudential perimeter to respond to systemic risks, or could a more timely mechanism be of benefit? What alternative mechanisms could be used?
- What accountability processes would be necessary to accompany any new mechanism?
- What criteria could determine when an institution or activity was subject to heightened regulatory and supervisory intensity?

Deloitte comments:

The Interim Report comments on adjusting the prudential perimeter to enable improved management of systemic risk. This raises questions of how to adjust the perimeter and how far it should extend. The goal of adjusting the perimeter should not be to eliminate risk. Eliminating risk would imply a static system with no innovation, and thus no new value creation for consumers. The focus should instead be on balancing the benefits of risks against costs. As noted by RBA Governor Glenn Stevens[31]:

> *"It equally follows that we are not trying to extend the regulatory 'perimeter' indefinitely. There will always be some risky activity around the fringes of the system, and there is nothing particularly wrong with that. Those who seek high returns, and are prepared to accept the risk, should be allowed to do so. There is value in that occurring… This is perhaps the greatest regulatory challenge for the future: assessing when an activity that is technically outside the 'perimeter' might be about to present a threat to overall stability."*

The changing nature of financial services, particularly changes enabled by technology, increases the possibility that non-traditional and unregulated players could become increasingly involved in providing financial products and services.

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[31] Stevens, G., 2014. *Speech to the Federal Reserve Bank of San Francisco's Symposium on Asian Banking and Finance*. http://www.rba.gov.au/speeches/2014/sp-gov-100614.html

This increases the likelihood that systemic risks may emanate from outside the regulated core of the financial system. Importantly, any extension of regulation should be based on a considered analysis of the costs and benefits, as outlined in Section 1.2. Meanwhile, in the spirit of preparedness over prediction, Australian regulators should continue to monitor developments to see whether any changes, including to boundaries, need to be made. Governor Stevens explains that[32]:

> *"Having the big things inside the perimeter about right should be good enough. After that, we need to make sure we devote adequate resources to keeping a general weather eye on the broader situation, beyond just the area illuminated around our current lamp post."*

The rationale for expanding the prudential perimeter should be based on a considered analysis of the costs and benefits. Regulators should continue to closely monitor market developments (including institutions and activities) to see whether changes are warranted.

7.2.2 Macroprudential powers

The Interim Report notes that a number of jurisdictions internationally have implemented macroprudential policies which are intended to improve their economies' resilience to shocks emanating from the financial system.

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

- No change to current arrangements.
- Introduce specific macroprudential policy tools.

Deloitte comments:

To date, Australia's financial system and its current approach to dealing with systemic risk – which consists of informal discussions between APRA and RBA, public communication and limited macroprudential powers – has proven to work well, including during the GFC. Some countries have introduced additional macroprudential measures intended to help in the case of a 'bubble'. Australian regulators have expressed their satisfaction with the current arrangements.

There are a number of reasons against a move towards a tighter macroprudential framework, with Deloitte supporting the RBA's view in this regard:

- As seen during the GFC, systemic risk can be very difficult to predict, define and contain narrowly. So far, the economics literature has struggled to produce an effective early warning system that would allow for a timely response.[33]

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[32] Stevens, G., 2014. *Speech to the Federal Reserve Bank of San Francisco's Symposium on Asian Banking and Finance.* http://www.rba.gov.au/speeches/2014/sp-gov-100614.html

[33] Access Economics, (2010) *Early warning systems: can more be done to avert economic and financial crises? Report prepared for the Institute of Chartered Accountants in Australia*.

To address risks in a formulaic manner (by switching a set range of measures on/off) is problematic and may in fact be counterproductive (e.g. measures being introduced too late in a cycle can make things worse).

- Australia already has two bodies dealing with macro-stabilisation: the RBA (through interest rates) and the government (through policies addressing unemployment). Additional measures are likely to create tensions between the responsible agencies about which levers to pull. APRA – with its knowledge of individual institutions – already provides inputs into the RBA's interest rate decisions.
- Finally, as noted by the Inquiry, international evidence around the effectiveness of macroprudential measures (such as loan-to-value ratio (LVR) caps and countercyclical capital buffers) is mixed. This is further supported an assessment of New Zealand's macroprudential measures.[34] In fact, Australia's own experience with quantitative lending guidance, abolished in 1984, highlights its flaws, with such measures leading to distorting effects to the efficient allocation of capital and resulting in financial institutions inventing ways to get around them.

A better alternative is a continuation of what Australia has done in the past, i.e. oversight of lending institutions as well as APRA and the RBA talking through any pressure points. This capacity could be enhanced by, for example:

- **Increased reporting at the individual company level on potential risks and resilience to economic shocks:** This could involve the disclosure of better information to regulators, including prospective (as opposed to retrospective) information and assessment of business model and potential risks in annual reports or increased stress testing.[35]

Existing frameworks have proven sufficient for the management of macroprudential stresses in the economy, and absent concrete global standards Australia has no need to pursue such tools unilaterally.

[34] Tripe (2014) outlines that New Zealand has adopted measures including restrictions to loan to value ratios and higher capital requirements for the internal models banks (the Australian big four) for high LVR loans, while Australia – despite the similar circumstances in both countries' housing markets - has not. His paper notes that, so far, there is limited evidence as to the severity of the problem that macroprudential policy in New Zealand is designed to address, and as to its effectiveness.

[35] Access Economics (2010) *Early warning systems: can more be done to avert economic and financial crises? Report prepared for the Institute of Chartered Accountants in Australia*.

Tripe D (2014) *If New Zealand needs macro-prudential policies to control house prices, why doesn't Australia need them? Paper for presentation at the Melbourne Money and Finance Conference*

Ellis, L. (2013) *Macroprudential policy: What have we learned?.* http://www.bankofengland.co.uk/research/Documents/ccbs/Workshop2013/Paper_Ellis.pdf

Creighton, A. (2012) *Sending banking back to the future*. http://www.theaustralian.com.au/business/opinion/sending-banking-back-to-the-future/story-fnc2jivw-1226456972401

7.3 Implementation of international prudential frameworks

There are concerns about how international prudential frameworks are being implemented in Australia.

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

- No change to current arrangements.
- Maintain the current calibration of Australia's prudential framework.
- Calibrate Australia's prudential framework, in aggregate, to be more conservative than the global median. This does not mean that all individual aspects of the framework need to be more conservative.

The Inquiry seeks further information on the following areas:

Is there any argument for calibrating Australia's overall prudential framework to be less conservative than the global median?

Deloitte comments:

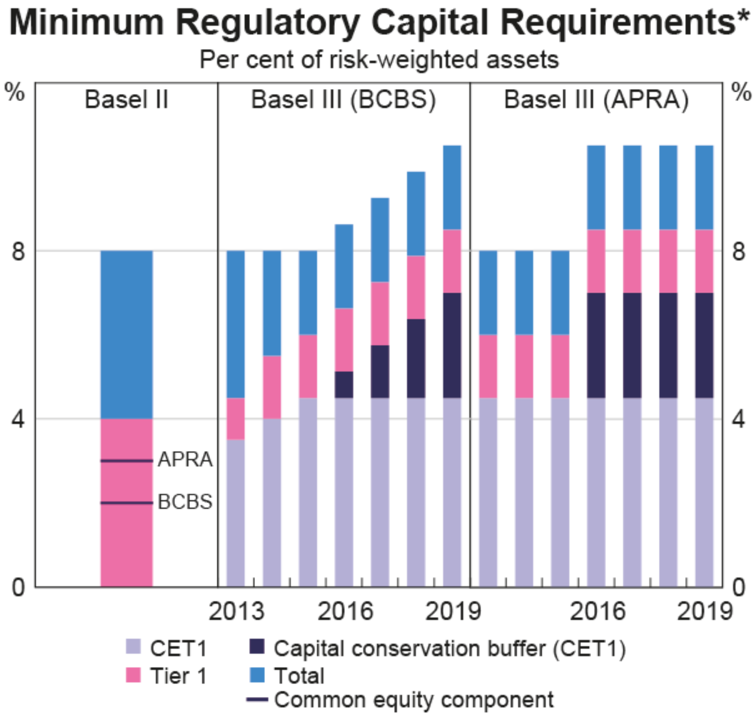
The effectiveness of a regulatory environment is dependent on the:

1. Legal framework in which the regulations operate.
2. Quality of the regulations.
3. Extent and quality of supervision of the regulations.
4. Effectiveness of the enforcement of the regulations.

It is important that these factors are considered when making international comparisons. Australia's robust regulatory regime is well-regarded internationally and helped protect our financial system during the GFC. The demonstrated effectiveness of regulatory outcomes in Australia reflects the legal framework, the quality of supervision, and the effectiveness with which the regulations were enforced as well as the quality of the regulations.

Australia's regulatory regime is conservative by international standards. APRA not only required ADIs to meet its new capital requirements at the start of 2013 (six years ahead of the BCBS' phase-in deadline), but it is also requiring ADIs to meet the full capital conservation buffer standards at the start of 2016 (three years ahead of the BCBS' phase-in deadline), as illustrated in the chart below from the RBA's *Financial Stability Review – September 2013*.

Table 7.1: Minimum regulatory capital requirements



* All dates are as of 1 January; minimum regulatory capital requirements are not directly comparable due to differences in definitions and differences in phase-in arrangements for Basel III

Sources: APRA; BCBS

An overly conservative prudential framework could distort lending by pushing banks towards excessive, or sub-optimal, lending for safer assets, such as housing, and away from riskier, yet worthwhile, activities, such as business lending.

APRA should **start by introducing capital requirements that are not more conservative than global benchmarks**, and do so in line with the global schedule. APRA can then make a case for introducing tougher regulatory requirements, or to bring forward their introduction. That is, there should be a more structured process for considering the costs and benefits of exceeding global requirements before implementing them.

Given the strength of the legal framework in this country, as well as the strength of supervision and effectiveness of enforcement, consistency with minimum regulatory requirements should be a starting point when new international standards are adopted in Australia unless there is a clear benefit from more conservative standards or faster implementation.

7.4 Corporate governance

7.4.1 Requirements on boards

The quality of corporate governance has repercussions for the financial system.

> **The Inquiry seeks further information on the following area:**
>
> Is it appropriate for directors in different parts of the financial system to have different duties? For example, differences between the duties of directors of banks and insurers and trustees of superannuation funds. Who should directors' primary duty be to?

Deloitte comments:

We do not think it is appropriate for **directors in different parts of the financial system** to have different duties. Australia, as a member country of the Financial Stability Board, is committed to strengthening adherence to international financial standards necessary to protect against adverse cross-border, regional and global developments affecting international financial stability. Given the financial systems are increasingly connected, the principle of consistency is crucial in promoting financial system confidence and trust with key stakeholders. These key stakeholders would include shareholders, investors, debtors, employees and customers.

APRA Level 3 conglomerates and CPS standards (CPS 220 Risk Management and CPS 510 Governance for example) are designed to harmonise the governance and risk management requirements across regulated entities such that base line responsibilities would remain consistent. Whilst the trustees of superannuation funds are regulated under different standards (e.g. SPS 220 Risk Management and SPS 510 Governance), there is an expectation that these requirements will align towards CPS 510 requirements in the future.

Consistency of duties would provide confidence to investors, shareholders and various stakeholders that the directors are responsible to ensure an effective risk management framework. There are clear expectations that the directors will pay sufficient attention to risk management and set up effective structures such as a dedicated risk committee, to facilitate meaningful analysis of the firm's risk exposures and to constructively challenge management's proposals and decisions.

Inconsistency of duties, on the other hand, may create confusion and dampen confidence among stakeholders.

> **There is no clear evidence to support why different duties should exist between directors of financial institutions operating in different parts of the financial system.**

8 Consumer outcomes

8.1 Assessing the regulatory framework

8.1.1 Disclosure

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

- No change to current arrangements.
- Improve the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators.
- Remove disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using technology and electronic delivery.
- Subject product issuers to a range of product design requirements, such as targeted regulation of product features and distribution requirements to promote provision of suitable products to consumers.
- Provide ASIC with additional powers such as:
  - Product intervention powers to prescribe marketing terminology for complex or more risky products.
  - A power to temporarily ban products where there is significant likelihood of detriment to consumers.
- Consider a move towards more default products with simple features and fee structures.

The Inquiry seeks further information on the following areas:

- Do similar issues in relation to the PDS disclosure regime apply to prospectuses, and is there a need to review prospectus requirements?
- What evidence is there on the effectiveness of financial literacy strategies in enhancing consumer confidence and decision making at particular points in time, and in achieving increasing literacy over the long term?

Deloitte comments:

The current financial system has moved to a point where individuals are responsible for looking after more risks, including financial risk and retirement income risk. Individuals should be provided with appropriate information to help them manage these risks. The existing disclosure regime is appropriately aimed at providing information which allows individuals to make informed financial decisions. However, Australian consumers are heterogeneous with varying degrees of financial literacy, capabilities and preferences. In practice, most consumers do not have the ability or willingness to fully, or even partially, digest lengthy disclosures, particularly for more complex products. Technological developments may exacerbate this problem. For example, individuals purchasing products on mobile devices are highly unlikely to read multiple page disclosures.

This means a variety of responses are required, rather than a one size fits all approach. Standardisation of disclosure is not the answer. Instead, consumers should be provided with advice and information of different forms and levels of complexity to cater more effectively to individual needs.

Technological developments should help enable this. For example, consumers could respond to a small number of questions regarding their self-assessed level of financial literacy, level of engagement and other factors. Based on these responses, different levels of disclosure could be provided.

We endorse the use of behavioural 'nudges' by both ASIC and the regulated population as a means to encourage appropriate choices for less sophisticated consumers. This could include placing members in default arrangements unless they opt out and elect more sophisticated products, for example in superannuation.

Providing appropriate information can also help to facilitate better consumer choices. Technology can help to achieve this by facilitating comparable disclosure of information, which can be accessed and compared through aggregators and other services. This may be less effective for more complex products which have multiple dimensions.

Regulators should not look to mandate or require certain product design features, as this could stifle innovation. It could also be exploited, as there would be continuing questions over practicalities such as: which features should be mandated and defining the perimeters around these; which regulator was responsible for choosing them; how these requirements would be monitored and enforced; and why certain features were chosen. Such an extension of regulator obligations would also result in an increase in moral hazard.

However, in some cases there are clearly products which are not appropriate for retail investors and consumers. We support providing ASIC with additional powers, and the ability to enforce them, to ban products which are assessed as being inappropriate. This would allow ASIC to react quickly to market developments. However, ASIC should be mindful of the trade-offs in banning products, noting that it can hinder innovation, as well as raising compliance and enforcement costs. Further, these rules may be difficult to apply, given heterogeneity amongst investors and products and the resources that developing and enforcing the rules would require.

Improving current disclosure requirements by leveraging technology to provide layered disclosure and online comparators would enhance consumer outcomes.

To support the changes in disclosure requirements, ASIC would be given additional powers, and the ability to enforce them, to ban inappropriate products.

8.1.2 Financial advice

8.1.2.1 Adviser competence

> **The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:**
>
> - No change to current arrangements.
> - Raise minimum education and competency standards for personal advice (including particular standards for more complex products or structures, such as SMSFs) and introduce a national examination for financial advisers providing personal advice.
> - Introduce an enhanced public register of financial advisers (including employee advisers) which includes a record of each adviser's credentials and current status in the industry, managed either by Government or industry.
> - Enhance ASIC's power to include banning individuals from managing a financial services business.

Deloitte comments:

Increasing product complexity means that there is a need for financial advice at different levels which appropriately caters to individual needs. There is a cost to government (e.g., higher pension costs resulting from less effective savings and retirement outcomes) and individuals (e.g. sub-optimal individual outcomes) of not getting this right. Clearly, the provision of appropriate, trustworthy advice is important. Financial advisers have a position of influence and are generally trusted by their clients who may be less well informed. This can cause principal-agent issues; advisers may not be properly trained, take inappropriate risks, or not act in the best interests of their clients. Developed countries have adopted different approaches to ensuring adviser competence, as shown in Table 8.1.

Table 8.1: Comparative standards

Jurisdiction	Qualification	Complaints
UK[36]	• Level 4+ (= first year university) with exam • Annual Statement of Professional Standing – requires qualifications, code of ethics, Continuing Professional Development	• All regulated financial services companies must have internal complaint handling • If it is felt that the complaint was not dealt with satisfactorily, the financial ombudsman can be enlisted to conduct an investigation and award compensation
Canada	• Licenses are required to sell life insurance, securities, and/or mutual funds. • Must register with the local securities regulator. • Financial advisers must carry Errors and Omissions Insurance	• Ontario Securities Commission (OSC) investigates breaches of law and conduct against the public interest, and can impose sanctions. • Investment Industry Regulatory Organization of Canada and Mutual Fund Dealers Association of Canada may also investigate if the offending firm is a member of these organisations.

[36] National Careers Service (2012) *Job profiles - Financial adviser*. https://nationalcareersservice.direct.gov.uk/advice/planning/jobprofiles/Pages/financialadviser.aspx

Jurisdiction	Qualification	Complaints
USA[37]	• No state or federal law requires credentials. Many states require advisers to pass a proficiency exam or meet other requirements. • Non-governmental certification bodies exist – the Certified Financial Planner (CFP) requires a bachelor's degree, completion of education and an exam specific to the CFP, three years' experience, background checks and an ethics declaration. • Must register with state regulator if they are managing less than \$100 million, and with the SEC if they manage more. This may differ between states.	• The Securities and Exchange Commission (SEC), Financial Industry Regulation Authority (FINRA) and the North America Securities Administrators Association (NASAA) all aid in identifying and prosecuting violators, but neither body is authorised to provide legal representation or recover funds on an individual's behalf.
Japan[38]	• No required qualifications • Must register with the federal body to be a financial adviser • Must make a deposit of 5 million yen (approx. A\$52,000) with the relevant government office, held as a reserve for clients claims arising in connection with advice	• Required to install a chief compliance officer

Advice is important, but needs to be provided at different levels of depth. This can be supported by raising minimum education and competency standards for personal advice, as well as setting up a public register of licensed financial advisers which includes a record of each adviser's credentials and current status in the industry. This should be managed and monitored by government or a government representative to ensure impartiality and bolster consumer confidence.

However, these requirements will impose additional costs – both of compliance and training/staffing costs. As such, these requirements should be scalable as appropriate to the type and complexity of advice for which the adviser is authorised to provide. This ensures that those who seek comprehensive advice can be more certain of its appropriateness, while individuals who only need limited advice or product information can still access this in a cost-effective manner. Effective enforcement is an important aspect of effective regulation. Given the difficulties consumers have in assessing the quality of the advice they are receiving, ASIC's powers to ban individuals found to be in breach of financial advice standards should be assessed to ensure they remain adequate.

Raising minimum education and competency standards for personal advice would signal advisor competence, enhance trust and improve consumer outcomes. Ensuring ASIC has adequate powers to ban individuals would strengthen the effectiveness of financial advice regulation.

[37] Office of Investor Education and Advocacy, Securities and Exchange Commission, *Investment Advisers: What You Need to Know Before Choosing One*. http://www.sec.gov/investor/pubs/invadvisers.htm

[38] MacHarg, Marcia L. & Berman, Kenneth J. (eds) (2012) *International Survey of Investment Adviser Regulation*, pp. 527–560. http://www.jurists.co.jp/en/publication/tractate/docs/MacHarg_ISI_Japan.pdf

8.1.2.2 Accessibility

The Inquiry seeks further information on the following areas:

- What opportunities exist for enhancing consumer access to low-cost, effective advice?
- What opportunities are there for using technology to deliver advice services and what are the regulatory impediments, if any, to those being realised?
- What are the potential costs or risks of this form of financial advice, and what measures could be taken to mitigate any risks?

Deloitte comments:

A majority of consumers already have access to low-cost scaled advice. This is generally provided by superannuation funds to their members. According to a 2014 ASFA survey[39]:

> *"All the funds surveyed provide general advice. Provision of scaled advice is also relatively common with around 75% of the funds surveyed providing scaled advice. … Funds provide advice to members on a broad range of topics related to the interest of the member in the fund and, in some cases, their broader financial circumstances. These range from retirement planning and transition to retirement strategies to decisions about contribution levels, investment choice and insurance coverage. … At least 57% (and possibly up to 87%) of scaled advice is collectively charged for [through general administration fees]."*

Given advice is broadly accessible, even at low costs (e.g. through scaled advice), the issue appears to be whether individuals are aware of potential sources for advice. There is significant potential for technology to provide high volume scaled and general advice. For example, an individual seeking advice could provide personal details using a short online form, which could be used as a basis for generalised scaled advice about typical financial issues (e.g. superannuation consolidation, retirement incomes, insurance, banking products, etc). The main potential issues associated with this are liability-related. There is the potential that **an individual** receives and acts on sub-optimal advice. This could have legal and regulatory implications.

Protective disclosure requirements have prevented advice providers from making advice more accessible through technology. Greater access to scalable advice should be accommodated through scalable disclosure requirements. That is, appropriate regulatory and disclosure requirements to the nature and scale of the advice being provided.

A majority of consumers already have access to low-cost scaled advice. Technology could reach further and improve awareness. Appropriate regulatory requirements for the nature and scale of the advice are necessary.

[39] The Association of Superannuation Funds of Australia Limited (2014) *ASFA survey on the provision of financial advice by superannuation funds.* http://www.superannuation.asn.au/ArticleDocuments/1089/1402-ASFA-survey-provision-financial-advice.pdf.aspx

8.1.2.3 Independence

The Inquiry seeks further information on the following areas:

- Is there a case to more clearly distinguish between independent and aligned advisers, and what options exist for doing this?
- Would consumers be likely to understand the difference between aligned and independent advisers and, if so, to what extent would this be likely to factor into a consumer's decision to take the advice?
- Would consumers be likely to be sensitive to differences in the price of independent or aligned advice?

Deloitte comments:

Consumers are capable of understanding the difference between independent and non-independent advisers. According to a 2010 JPMorgan survey[40],

> *"One in five people who have used an adviser in the past say that the independence of their advice one of their main benefits. Equally, a third of people who reject the idea of seeking financial advice do so because they are concerned about product/provider bias. When it comes to defining independence, consumers are more likely to equate it with lack of bias rather than exhaustive product knowledge. Seventy-eight percent of those who use or intend to use a financial adviser say it is acceptable for an adviser to advise on "a wide range of products and providers". Only 29% believe a professional adviser should advise on "every single product and provider on the market."*

Survey evidence from the UK shows that consumers prefer independent advice.[41]

> *q32. Today, financial advisors have to offer either independent advice (the advisor can provide advice on products and services from the whole of the market) or restricted (the adviser can provide advice on certain types of product, or on products from one or a limited number of providers). Which type of advice would you like to have?*
>
> *Responses: Independent advice (69%) Restricted advice (5%) Don't know (27%)*

Providing more effective and transparent information will help consumers to better understand what services they are purchasing, and make decisions accordingly. Effectively it allows principals to become more aware of the incentives and scope of agents. One way to achieve this could be by following the UK path, and explicitly defining advisers as restricted or independent. Advisers should then be required to disclose their classification in all communications and marketing materials.

However, although consumers prefer independent advice, only a few appear to be willing to pay for it.[42]

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[40] JP Morgan Asset Management (2012) *Winning propositions: The consumer market post-RDR*. http://am.jpmorgan.co.uk/adviser/_documents/jpm-winning-propositions.pdf

[41] YouGov (2014) *RDR Survey Results: Wave 5*

q33. Would you be prepared to pay more for your favoured type of advice?

Responses: Yes (21%) No (53%) Don't know (26%)

Consumers appear to be able to understand the difference between aligned and independent advisers and to consider this when making decisions.

However consumers are sensitive to the cost of independent advice. As a result access to low-cost scaled advice is important.

8.1.2.4 General advice

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

- No change to current arrangements
- Rename general advice as 'sales' or 'product information' and mandate that the term 'advice' can only be used in relation to personal advice.

Deloitte comments:

Increasing product complexity means that there is a need for financial advice at different levels to cater appropriately to individual needs. We have noted the opportunity for technology to improve consumers' accessibility to product information. Information asymmetries mean that consumers may not be aware of the nature of advice, including its independence, personalisation, or whether it is marketing/sales type advice. This could lead to consumers inadvertently picking products which are not best suited to their needs. Ensuring different types of advice are named to clearly identify the exact type of service provided to consumers can help to address this.

In the case of general advice, assuming current conflicted remuneration legislation is to remain, 'sales information' or 'product information' is a more accurate reflection, and would allow consumers to understand the context of the advice and make decisions accordingly. In principle, the term 'advice' should only be used in relation to a service or information that is subject to regulatory requirements that help ensure the information is free of conflicts and in the consumer's best interest as much as reasonably possible. Renaming general advice as 'sales information' or 'product information', and restricting 'advice' to personal advice is likely to reduce any confusion on what constitutes advice. It may also enhance the ability to assess the value they place on independent advice.

Sales' or 'product information' is a more accurate reflection of the content, and would allow consumers to understand the context of any advice provided and make decisions accordingly. The use of the term 'advice' should be restricted to personal advice that meets specific regulatory requirements.

[42] YouGov (2014) *RDR Survey Results: Wave 5*

8.1.3 Other consumer issues - Underinsurance

The Inquiry seeks further information on the following areas:

- Does Australia have a problem with underinsurance that warrants some form of policy response? Specifically:
  - How does Australia compare internationally on adequacy of insurance coverage?
  - Has the issue of underinsurance been increasing over time?
  - What evidence and data are available to support a conclusion about our level of underinsurance?
  - What evidence and data are available to assess whether more granular risk-based pricing will lead to exclusion or further underinsurance?
- If warranted, what are possible approaches to lessen the existence of, or mitigate the impact of, underinsurance?

Deloitte comments:

A definition of underinsurance is: 'The members of the household face a material fall in their standard of living following an insurable event and/or there is a material increase on calls on the public purse'. Based on this definition, the call on the public purse following natural disasters, such as the Brisbane floods, indicates that underinsurance is present. However, government assistance in these circumstances typically is without recourse and does not take into account the circumstances of the individuals and households.

Building resilience to natural disasters – through community education, provision of risk information, adaptation research and mitigation infrastructure – can reduce the call on the public purse, neutralise the issue of information gaps about recipients and reduce underinsurance.[43]

Underinsurance against risks in retirement, including longevity risk, aged care costs and increased health care needs are addressed in Section 10.2.

Greater investment in disaster mitigation measures will reduce the impact of underinsurance.

[43] Deloitte Access Economics (2014) *Building our nation's resilience to natural disasters*. http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Services/Corporate%20Finance/Access%20Economics/Deloitte_Natural_disasters_June2013.pdf

9 Regulatory architecture

9.1 Regulatory perimeters

9.1.1 Retail payment systems regulation

> The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:
>
> - No change to current arrangements.
> - Consider a graduated framework for retail payment system regulation with clear and transparent thresholds.
>
> The Inquiry seeks further information on the following areas:
>
> - Is there firm evidence to support opportunities for simplifying the regulatory framework for retail payment systems and participants?
> - What are practical and appropriate options to simplify the current regulatory framework for retail payment systems and participants?

Deloitte comments:

Regulation needs to strike a balance between stability, efficiency and competition. There is evidence in some areas of the payments system that regulatory complexity or overlap create unnecessarily high barriers to entry that may inhibit competition and innovation.

The public interest benefits of new entrants in payment infrastructure can be large. Entrants often deploy newer systems that represent improvements over incumbents' legacy systems (for example, the major banks have all suffered from significant legacy system-related outages in recent years). New entrants can also take advantage of technology advancement allowing greater flexibility or lower cost than legacy systems, enabling them to be quicker to market with new services and to disrupt the traditional cost paradigm favouring economies of scale.

At a systems level, the RBA, through the Payments Systems Board, appears to work well in preserving stability whilst working with industry to reduce settlement risk. Recent examples include shorter clearing times in the cheque system, intra-day direct entry payments settlement and the move towards real-time payments via the New Payments Platform (NPP). In terms of regulatory jurisdiction, however, there are overlaps that can cause confusion and inefficiency.

For example, non-cash payment facilities such as supermarket gift cards and rechargeable cards are subject to duplicated regulatory requirements. The Payment Systems Board currently limits supermarket gift cards to a maximum balance of $500. These cards could also be regulated by ASIC if it were to enforce a prohibition on sending an unsolicited debit or credit card. Whether it would do so is currently unclear as pre-paid cards did not exist when the legislation was drafted.

Given the limited risk to the system inherent in these products, a simplification would be appropriate (while taking into consideration consumer protection interests). This example also suggests a need for a regulatory framework that is agile and able to respond to changes in technology and payments products and services on a timelier basis. There are further issues relating to access to the payments systems which have been identified by the RBA itself. For example, it has cited the SCCI access regime as being more restrictive than necessary[44]. The RBA has announced it will vary the access regime applying to MasterCard and Visa systems and will seek removal of the SCCI framework. This shift of oversight responsibilities from APRA to the schemes (who will be required to set transparent risk-based criteria) is a useful model for matching levels of regulatory impost and risk. Another example where this may apply is for access to NPP, which is currently limited to ADIs, although there are indications that this will change as the regulatory framework is clarified.

Regulatory overlap should be minimised to eliminate misalignment and duplication of regulation – which can create confusion and additional compliance costs for market participants – but also to refocus regulators' time and resources on core responsibilities. Any regulatory framework should also be sufficiently flexible to balance risk and regulatory impost in a dynamic and changing environment. In the gift card example, given ASIC already provides various regulatory exemptions and relief to non-cash payment facilities (e.g., to certain loyalty programs), the necessity and scope of the current regulatory regime should be reviewed. The current regulatory requirements and restrictions are arguably overly restrictive given the low risks associated with these products.

Payments and cards trends in Australia are broadly consistent with similar developed economies in the US, UK, Canada, and countries in the EU[45]. Australia therefore faces similar challenges in managing change. A common theme across jurisdictions is providing greater access, and better matching risk and oversight levels. For example, the UK has announced establishing a Payments System Regulator (PSR) to replace the industry-led Payments Council that was seen to have failed to sufficiently address access to the UK payment systems, the terms offered for access and the industry's pace of innovation.[46]

At a European level the 'Payment Institutions' framework was established to regulate entities which were not already covered by banking or e-money regulations, in part because prospective participants had found the then-existing regulation too restrictive for the services they wished to provide. Accordingly, the current framework establishes a prudential regulatory regime that takes into account the different operational and financial risks posed by payment services. Once an entity is authorised to provide one or more of these services by the national regulator responsible for its prudential supervision, it can offer those services throughout the European Union.[47]

[44] Reserve Bank of Australia (2013) *Proposed Variation to the MasterCard and Visa Access Regimes: Consultation Document – December 2013*. http://www.rba.gov.au/publications/consultations/20131206-prop-variations-to-mc-visa-access-regimes/preliminary-assessment.html

[45] Reserve Bank of Australia (2014) *Submission to the Financial System Inquiry*, p. 198

[46] Financial Conduct Authority (2014) *Payment systems.* http://www.fca.org.uk/about/what/regulating/payment-systems

[47] Reserve Bank of Australia (2013) *Proposed Variation to the MasterCard and Visa Access Regimes: Consultation Document – December 2013*. http://www.rba.gov.au/publications/consultations/20131206-prop-variations-to-mc-visa-access-regimes/reasons-for-review-regulation.html#f3

In the United States, the payments landscape is fragmented and complex, with more than 20,000 deposit-taking institutions offering payments services and an array of regulators at the state and federal level. Recent reviews by the Federal Reserve argue against additional regulation, but rather focus on active monitoring, risk management, industry consultation and consumer education.[48] One example of this is the Fed's adaptive response to Bitcoin, which has focused on quickly understanding and assessing the situation and then addressing potential risks to the system through regulation of the Bitcoin exchanges (which, unlike Bitcoin itself, are under its regulatory purview). Jurisdictions have also needed greater regulatory harmonisation, with the EU mandating the Directive on Payment Services (PSD) as a 'maximum harmonisation' initiative.[49] Similarly, avoiding 'balkanisation' to avoid regulatory arbitrage is an explicit goal of the Federal Reserve in the US.[50]

Given the potential for confusion created by regulatory overlap and the potentially high barriers to entry for some payment providers, **Deloitte supports a graduated framework** that allows for a more proportionate approach matching the relative risk with the regulatory impost. This would likely lower barriers to entry to attract new entrants, improving competition, choice and efficiency.

A graduated framework for non-ADIs might adopt monetary thresholds based on the level of financial risk or exposure. Functional thresholds based on the level of risk posed by the nature and scope of activity may, however, be more appropriate ways to separate the gradations. For example, low risk entities might need only comply with a basic registration regime (with a focus on consumer protection), those in a middle tier could be made to submit to a general licencing regime (with a focus on competence and compliance) with a highest tier involving both general and prudential licensing (including capital requirements, governance, systems and controls). Such a framework would seek to balance predictability and agility by being principles-based rather than articulating prescriptive rules.

Such a framework could provide transparency and offer better access to designated systems by new entrants. Where possible, oversight of access regimes might even be devolved to bodies closer to the management of the systems (for example, APCA in the case of NPP) as long as risk is managed transparently and overall regulatory objectives of the RBA are met. This would allow the bank to focus on other priorities rather than assessing and managing operational access to aspect of the payments system it does not directly control. Combined with a principles-based approach, this could provide for the flexibility that will be required for our regulatory system to effectively manage the high level of change that is expected in the future.

A graduated framework for regulating retail payments is appropriate.

[48] Crowe, M., Kepler, M., Merritt, C. (2012) *The U.S. Regulatory Landscape for Mobile Payments*. http://www.frbatlanta.org/documents/rprf/rprf_pubs/120730_wp.pdf

[49] European Commission (2014) *Directive on Payment Services (PSD)*. http://ec.europa.eu/internal_market/payments/framework/index_en.htm

[50] The Federal Reserve Board (2014) *Record of Meeting - Federal Advisory Council and Board of Governors - Friday, May 9, 2014*. http://www.federalreserve.gov/aboutthefed/fac-20140513.pdf

9.2 Regulator structure and coordination

> The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:
>
> - No change to current arrangements.
> - Consider increasing the role, transparency and external accountability mechanisms of the CFR:
>   – Formalise the role of the CFR within statute.
>   – Increase the CFR membership to include the ACCC, AUSTRAC and the ATO.
>   – Increase the reporting by the CFR.

Deloitte comments:

The Council of Financial Regulators (CFR) provides a high-level forum for cooperation, collaboration, and information exchange on financial sector policy between APRA, ASIC, the RBA, and the Australian Treasury. There are concerns the CFR relies on informal cooperation, is not pro-active, and is unaccountable. The suggestion that the CFR's role be formalised to address these concerns is not new. However, **Deloitte does not support formalising the CFR's role** as it would only create additional bureaucracy and red tape.

The Australian Treasury, via the Treasurer, already acts as a coordination agency between APRA, ASIC and the RBA. These arrangements and the current structure of the CFR performed effectively during the GFC which supports their continuation. Furthermore, a joint APRA/RBA paper on domestic financial stability policy (prepared for the IMF's Financial Sector Assessment Program review of Australia in 2012) indicates that the existing CFR arrangements "…provide a flexible, low-cost approach to coordination among the main financial regulatory agencies".

Formalising the CFR is unlikely to improve agency coordination in this respect. It is important to note that formalising the CFR and by extension the frameworks for financial stability coordination are not a guarantee of success. In particular, they may not necessarily create a culture of cooperation and support between the regulatory agencies, which are essential elements of an effective financial stability framework (especially during a crisis). To an extent, open lines of communication are already fostered by the current operations of the CFR which convenes on a quarterly basis.

Finally, APRA, ASIC and the RBA are autonomous and are able to act independently. However, such **autonomy needs to be balanced against accountability**. A lack of accountability for the decisions regulators make can contribute to excessive regulation and intervention. Accountability could be facilitated by the Heads of the three regulators being required to individually appear before a House Economics Committee on a periodic basis.

> **Existing CFR arrangements contribute to effective regulatory coordination. The Inquiry should recommend increasing accountability of regulators, to guard against the risk of excessive regulation.**

10 Retirement income

10.1 Retirement income system

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

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

Deloitte comments:

The primary objective of the retirement income system should be to help individuals to fund their retirement. The retirement income system rests on three pillars – social security, mandatory superannuation and voluntary savings – and policy options need to take into account the interplay between these pillars. Policy options should be judged on how they help the system as a whole to efficiently assist individuals to manage their retirement risks and achieve their preferred retirement outcomes.

The complexity of the retirement income system is also increased because of the interaction with the tax system. The Interim Report observes (p4-21) that:

> *"The taxation and social security systems could be used to create strong incentives for retirees to take superannuation benefits as income streams that help manage longevity risk."*

Past policy decisions have added to the complexity, making it difficult for individuals to understand their retirement income options and actively participate in these complex decisions, as well as increasing the cost to consumers because of the need to obtain personal advice. Policy options should aim to simplify the system to make it easier to navigate and understand.

Previous taxation policy decisions, in particular the removal of tax on withdrawals from superannuation, have encouraged retirees to take lump sum payments instead of an income stream that would help them to manage longevity risk. Taxation of withdrawals at marginal rates would make the tax treatment consistent across the sources of retirement income. Importantly, it would also provide an incentive for retirees to effectively take a regular income stream annually rather than a lump sum payment. As the Interim Report notes, this was recommended in Australia's Future Tax System Review.

Market-based solutions are most effective when individuals understand longevity risk and are provided with suitable products to manage it. Where there is a gap in market-based solutions, **incentives** to encourage retirees to purchase retirement income products that help manage longevity and other risks can improve retirement outcomes. Incentives exist in overseas jurisdictions; for example, annuitisation was compulsory for retirees in the UK until recently.

However, **mandating individual retirement income products** is not recommended. There are costs associated with adopting a mandatory approach: a one size fits all approach is unlikely to suit the different circumstances faced by retirees; there are equity considerations, due to the positive correlation become income and longevity; and, it may not be competitively neutral. Indeed, the UK has moved away from compulsory annuitisation in part to address some of these costs. [51] The popularity of SMSFs further illustrates the importance that retirees place on choice and flexibility.

Existing account-based pensions can be complex. Introducing a **default retirement income option** would extend choice and provide a simple option for those who want it.

Given its complexity, and the interaction of the superannuation, social security and taxation systems, there has been a **reluctance to fundamentally review the system** in its entirety. Moving to a simplified system could be achieved with appropriate grandfathering.

The Interim Report notes that the policy settings in the tax and transfer system are outside the scope of the Inquiry's Terms of Reference. We believe that it is appropriate for the Inquiry to recommend that the broader retirement income system, **including tax**, should be reviewed.

In the absence of a comprehensive review, product based recommendations such as annuities, or policy based recommendations such as incentives to purchase annuities, need to account for the impact of further adding to the complexity of the retirement income system.

Changes which enable consumers to effectively manage their income and risk in retirement should seek to reduce complexity.

[51] Jones, R. (2014) *Millions of pensioners get poor deal, says FCA in damning report on annuity market*. http://www.theguardian.com/business/2014/feb/14/pensioners-poor-deal-fca-damning-report. The UK government made the decision, responding to public pressure for greater choice and following critical reports; e.g. the Financial Conduct Authority found the market did not cater well for retirees with small balances.

10.2 Retirement income products

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

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

The Inquiry seeks further information on the following areas:

- Would deferred lifetime annuities or group self-annuitisation be useful products for Australian retirees? Are there examples of other potentially suitable products?
- If part of retirees' superannuation benefits were to default into an income stream product, which product(s) would be appropriate?
- Will the private sector be able to manage longevity risk if there is a large increase in the use of longevity-protected products? How could this be achieved?
- Should Government increase its provision of longevity insurance? How would institutional arrangements be established to ensure they were stable and not subject to political interference?
- What are some appropriate ways to assess and compare retirement income products? Is 'income efficiency' a useful measure?

Deloitte comments:

Principles of competitive neutrality, and flexible regulation which accommodates innovation, underpin evaluation of policy options for retirement income products.

Longer-dated Government bonds, including inflation-linked bonds, have long been a missing piece of the market and there are suggestions from many industry players that this would be helpful in bolstering annuity supply. The US has a long-established 30-year Treasury benchmark and government yield curves run out to 50 years in some European countries. Extending the yield curve for Australian government bonds could also facilitate the development of other innovative retirement income products.

Many products could help Australian retirees have an income for life in retirement. **Deferred lifetime annuities and group self-annnuitisation** are on this list. Others products include:

- **Term annuities**, which pay an income for a fixed period. At the end of the term there may be a residual value of return of the premium paid.
- **Variable annuities**, which are account-based pensions with a guaranteed minimum income in the event the account runs out.
- **Participating annuities**, which produce a low guaranteed income with a discretionary addition based on the profits of the business. These are issued by life insurance companies, which must distribute at least 80% of the profits to annuitants.
- **Unit-linked annuities**, which pay an income for life based on the value of units in an underlying investment fund.

The purpose of **a default product** would be to provide an income for life apart from the age pension:

- A deferred lifetime annuity does not achieve this aim during the period up to the vesting age. It could be packaged with other products to meet this aim, e.g. term annuity.
- Term annuities do not produce an income for life if the annuitant lives longer than the term. They can be packaged with other products to resolve this issue, as above.
- The other products listed above do produce an income for life. They, together with appropriate packages of products, are suitable for being default products.

Life insurance companies in other countries do **manage longevity risk**. While there is only a small amount of longevity risk managed by Australian life insurers at present, we expect that they have the capability to manage a lot more. The gradual introduction of the large scale use of longevity-protected products would be more digestible, as would happen if it applied only to new retirees from a certain date. The Superannuation Industry Supervision Act (SIS), however, limits the types of income product that are tax exempt.

Of the products listed above, the following are not tax exempt and do not exist in Australia:

- deferred lifetime annuities;
- group self-annuitisation;
- participating annuities; and
- unit-linked annuities.

The private sector will be able to provide flexible products that meet different retirees' needs when the Tax Act permits a broader range of tax-exempt products. The cost of capital to support longevity-protected products reduces the return they can give to retirees.

The **government has an interest** in this as the lower the annuity the higher the cost of the age pension to the same person. The government may find it beneficial to reduce the capital cost of longevity-protected products, for example by covering a significant increase in Australian life expectancy itself. This could be achieved contractually and not just legislatively, say through a reinsurance contract between an insurer and the government. Governments should find it harder to breach contracts than to change legislation.

Retirement income product comparisons need to consider:

- the income is fixed or may change up or down unpredictably;
- the income is not fixed, but there is a minimum below which it will not fall;
- the income starts at different ages;
- the income lasts for life or may run out;
- the income may change, in the case of a couple, when the first of the couple dies;
- lump sum withdrawals may be permitted; and
- there may be an amount payable on death.

To compare them requires being able to understand how they perform in different circumstances. Presenting a range of circumstances will help annuitants to compare products in the light of their personal needs. However, this also will add to the complexity of an area that already is not well understood by individuals. The relevant circumstances include different:

- lifespans;
- inflation rates in future;
- interest rates in future;
- performances of investment markets; and
- a contingency for which cash is needed, e.g. moving into aged care or house repairs.

Income efficiency is useful but not perfect. Efficiency is higher for products with lower fees and charges, as it should be. Income efficiency is lower for products that contain valuable guarantees. It does not mean that they are worse products. The customer needs to weigh up the income provided against the guarantees and decide which product is most suitable. Income efficiency provides some context for that consideration, but not the answer.

Regulators should not mandate individual products, as individuals needs differ significantly.

The tax system could be used to encourage individuals to take an income stream rather than a lump sum.

Policies to encourage the development of products which enable consumers to effectively manage their income and risk in retirement should avoid increasing complexity.

10.2.1 Access to equity in the home

> **The Inquiry seeks further information on the following area:**
>
> • What, if any, regulations impede the development of products to help retirees access the equity in their homes?

Deloitte comments:

Equity Release Products (ERPs), which include reverse mortgages and home reversion schemes, are financial products that are expected to continue to experience growing demand as Australia's population ages. Reverse mortgages, which have been around since the 1980s, are the most common product with a market that continues to grow steadily, reaching $3.3 billion in 2012.[52] Home reversion schemes are relatively new and only available in certain areas of Sydney and Melbourne through a single provider.

The Productivity Commission estimated that accessing the equity in homes could significantly reduce aged-care funding needs.[53] Although there are no regulations impeding the development of the product, the lack of maturity in the market presents obstacles to increased uptake and dissemination of ERPs.

Developments, such as the introduction of the compulsory 'No Negative Equity Guarantee' in the National Consumer Credit Protection Act in 2011, which limits the risk associated with reverse mortgages, are key steps forward for the industry overall, but may not go far enough. [54] Other improvements to the current regime could include allowing:

- authorised financial planners to write the product, rather than only a mortgage broker;
- the product to be considered as a complying annuity stream product and treated consistently with lifetime or deferred annuities, if legislation is brought in to encourage annuities.

There also remains significant scope for government involvement to assist the market to mature. Options range from light intervention (e.g. improved financial literacy and regulation) to comprehensive public involvement in the market (e.g. long-term government provision on an income stream (lifetime annuities at market rates) rather than lump sum advances). As noted in our response to the 2011 Productivity Commission Inquiry on *Caring for Older Australians*, we recommend that government actively consider how best to remove obstacles to the development of the private market in equity release, rather than establish a government-backed equity release scheme (as was proposed by the Productivity Commission).[55]

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[52] Deloitte (2012) *Media Release: Australia's Reverse Mortgage Market Reaches $3.3bn at 31 December 2011*. SEQUAL Deloitte Research Report, 4 June 2012.

[53] Productivity Commission (2011) *Caring for Older Australians*. http://www.pc.gov.au/projects/inquiry/aged-care/report

[54] Shorten, B., Minister for Financial Services & Superannuation (2011) *New Consumer Credit Protections Introduction into Parliament*. http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/133.htm&pageID=003&min=brs

[55] Deloitte Access Economics (2011) *Response to Productivity Commission Draft Report: Caring For Older Australians*. Deloitte report prepared for Homesafe Solutions Pty Ltd. http://www.pc.gov.au/__data/assets/pdf_file/0014/108203/subdr600.pdf

11 Technology

11.1 Regulation in a digital environment

11.1.1 Technology neutrality

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

- No change to current arrangements.
- Amend regulation that specifies using certain technologies with the aim of becoming technology neutral. Amendments should enable electronic service delivery to become the default; however, they should include opt-out provisions to manage access needs for segments of the community.
- Adopt a principle of technology neutrality, for future regulation recognising the need for technology-specific regulation on an exceptions basis. Where technology-specific regulation is required, seek to be technology neutral within that class of technologies.

Deloitte comments:

Technology specificity is difficult to spot from afar. Australia's system of financial regulation does not have a great deal of overt technology specificity at the overarching legislative level, nor has it been laden with excessive information and communications technology language. For example, legislation such as the Banking Act 1959, the Financial Sector (Collection of Data) Act 2001 and the financial services regulations in the Corporations Act (2001) are largely technology neutral. Similarly, down in the detail, ASIC's regulatory guide (one of 250) on fee disclosure statements allows communication by a range of forms.[56]

And yet at another level, technology specificity abounds. Many regulatory structures have been built around specific technologies: for example, the RBA's payments system regulation (such as access regime for the ATM system or Interchange fees in the EFTPOS system) is technology specific. There are also many concepts built into the financial system regulatory architecture that are indirectly technology specific. For example:

- **Financial advice** – Big data analytics in the future will allow customers to enter their key personal metrics into a web tool so they can receive automated financial advice on financial sector products. So-called 'robo-advisers' are an example of interactive digital trends. There are already advances that allow people to receive medical advice – where risks are least tolerable – based on big data analytics so it is not hard to see extensions in finance. But with big data analytics providing advice, who is the adviser and how will they be regulated differently from humans?

[56] Australian Securities & Investments Commission (2013) *Regulatory Guide 245: Fee Disclosure Statements.* http://asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg245-published-1-March-2013.pdf/$file/rg245-published-1-March-2013.pdf

- **Activities that are prudentially regulated** – With the growth of online commerce, the facilitators of payments play a bigger role. Consider Alipay (part of Alibaba), which processed over $US500 billion in payments last year, and held funds in escrow, blurring the lines between the balance sheets of purchasers, suppliers and itself. How will processors be regulated vis a vis traditional financial institutions?
- **Payments –** With the growth of customer data as a source of value, could it be traded for non-monetary goods or services? Could data itself become a method of payment, and what are its implications for regulation? APRA's Prudential Practice Guide is structured around client data being information held on financial services clients rather than something of value in itself.

Technology specificity has costs and benefits – In situations where adopting new technology has network externalities, mandating change or having technology specific regulations has benefits. Australia's more technology specific approach to payments, compared with the more technology neutral US system, allowed a more rapid uptake of a single EFTPOS system in Australia.

On the other hand, in situations where technology specificity prohibits certain activity, it can hamper innovation. For example, *Kickstarter* is designed to allow crowdsourcing of new innovations; while it allows people to contribute money, they cannot offer loans or be able to take a stake in the new idea, raising questions for regulators on whether or not this is appropriate.

A workable program of reform – Deloitte's 2012 paper, *Digital Disruption: Short Fuse, Big Bang?* named Finance & Insurance as the sector impacted second by digital trends. The first, the media sector, offers some lessons for achieving technology neutral reforms.[57]

In media, the Australian Communications and Media Authority (ACMA) started with the principle of identifying 'broken concepts' in media legislation – regulatory concepts that no longer had relevance in a converging media landscape; and then created 'enduring concepts', the principles for reform. Then there was a media reform inquiry and an ongoing program of change.

For finance, a reasonable process would be to identify 'broken concepts' and 'enduring concepts' and use the former for targeted regulatory reform and the latter for future regulation going forward.

> **Technology neutrality is a sound ideal, but there can be practical challenges to achieving it, so any work program to reform legislation and regulations should be realistic and phased over time.**

[57] Deloitte (2012) *Digital Disruption: Short Fuse, Big Bang*, http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/news research/Building%20the%20lucky%20country/Deloitte_Digital_Disruption_Whitepaper_Sep2012.

11.1.2 Facilitating innovation

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

- Establish a central mechanism or body for monitoring and advising Government on technology and innovation. Consider, for example, a public–private sector collaborative body or changing the mandate of an existing body to include technology and innovation.
- Establish a whole-of-Government technology strategy to enable innovation.

The Inquiry seeks further information on the following areas:

- Are there specific areas in which Government or regulators need to facilitate innovation through regulation or coordinated action? For example, by facilitating the development of central utilities?
- Are there ways to improve how regulators monitor or address emerging technological developments? For example, through adopting new technologies or mechanisms for industry intelligence gathering?

Deloitte comments:

The Interim Report correctly identifies technology-led innovations as being important to the financial sector. It also correctly identifies the dual role of regulation: 'to be flexible so as not to stifle innovation while in some areas assisting in setting industry standards and overcoming coordination problems/disparate commercial interests and driving adoption of new technologies that have network externality benefits'.

Developing a policy and regulatory response to get the balance right is challenging.

Another body or strategy is not the answer – Neither the financial sector or technology, are at the apex of innovation. The Government already has The Prime Minister's Science, Engineering and Innovation Council (PMSEIC) to advise government on innovation (and science and engineering); it already has an innovation framework (Powering Ideas) and principles; a National Digital Economy Strategy; and the Australian Government Information Management Office (AGIMO) for strategy within government.

Comparing various technology transitions presents interesting learnings. Only rarely is it the case that centralisation or coordination was important and positive. Consider, for example, successful government mobile apps, like the Department of Social Services Express Plus Families app, which has been taken up in large numbers because it is useful. This can be contrasted with Personally Controlled E-Health Records that have not met take-up targets. In general, the best way to drive change is to provide customer value and sharpen market incentives for organisations to react to customer needs.

Careful balance of Innovation and Regulation – The government needs to be careful about balancing policy that fosters innovation with the prudent management of financial assets and the broader stability of the financial and payments system.

As previous experiences in Australia demonstrate, information asymmetries can create perverse incentives and lead to fraud. This is particularly important on three fronts: stored value, payment overlay services and lending.

- **Stored value** – The key question in stored value (e.g. digital wallets) is: when does stored value become a "deposit"? Is it based on the size of the individual deposit or is it when the collective size of stored value in one particular system begins to introduce system risk into the system? What is the trade-off of protecting individual customers vs. the economy? When does the regulatory impost required of ADIs result in an unfair playing field for the incumbents?
- **Overlay Services** – Innovation will be a critical part of the overlay services that are meant to be part of the NPP. How will the PSB ensure the robustness and stability of the payments system going forward? Who will be responsible to assess, validate and monitor these providers?
- **Lending** – There is clearly a lot of talk in the industry about the rise of P2P lending. These entities are getting increasingly sophisticated in the way that they distribute funds and provide potential lenders with risk assessments to help their decision making process. At the same time, who is verifying that these placements are actually taking place? Who is verifying the validity of the risk algorithms (there is a link here to the bureau question)?

Government does not appear to lack awareness of new technological developments. However financial market regulators may wish to consider a new mechanism for increasing awareness of the latest developments so they can understand change and make appropriate regulatory recommendations.

Australia has considerable innovation policy architecture for monitoring and advising government on technology and innovation; a new body or strategy is not needed.

Three areas the Inquiry could focus on are stored value, overlay services and new types of lending.

11.2 Managing information

11.2.1 Privacy

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

- Review and assess the new privacy requirements two years after implementation to consider whether the impacts appropriately balance financial system efficiency and privacy protections.
- Review record-keeping and privacy requirements that impact on cross-border information flows and explore options for improving cross-border mutual regulatory recognition in these areas.

The Inquiry seeks further information on the following areas:

- What options could be explored for providing consumers with more control over use of their data and/or better access to their own data in useful formats to improve decision making and consumer outcomes?
- What additional Government data sets could be released to improve consumer outcomes, industry analysis and public policy development via data.gov.au, taking into account relevant privacy requirements?

Deloitte comments:

Citizens and consumers are becoming increasingly aware of the value of their personal information and hence are looking for more privacy options. The default position of governments has been to revisit their privacy regulations. This approach, though, is doomed from the start as no regulation can possibly keep up with this rapidly developing information economy.

In fact, it is likely to be economic forces that will provide the solution to the privacy issues created by Big Data. Both government and businesses are beginning to realise that they can make individuals much more comfortable with sharing their data if, rather than providing an almost infinite (and incomprehensible) set of privacy settings, they simply renounce any attempt at taking over ownership of the data and simply borrow or lease it with the permission of the true owner – the consumer.

This approach is referred to as **personally controlled records** and is made possible by the databases that support the growth of Big Data. No longer is it necessary to extract every piece of information and replicate it many times over in order to support complex analytics. Rather it can be packaged as a neat record, kept in the control of the individual and purged upon expiry or the revocation of the lease that has been provided.

Rather than reducing the value to business and government, this approach actually opens up a huge array of new possibilities and leaves the individual in control. The evidence is growing that when people feel confident that they can withdraw their information at any time and are not at risk of unintended consequences they are much more willing to submit their data for a wide array of purposes.

The protection of the individual in a world of Big Data is not through better privacy, but rather through clarifying who actually owns the data and ensuring that their rights are maintained. In a fast-changing environment, the best direction for information privacy regulation is to ensure consumers are informed and offered choices rather than aspiring to a highly codified set of privacy laws.

Deloitte's 2014 Media Consumer Survey revealed that the ground was shifting in the personal information / fee for content trade-off.[58] Between 2012 and 2014, the proportion of people who said they would "willingly be exposed to more online advertisements if it meant I could receive free content that I found valuable" fell from 54% to 44%. Meanwhile, those who said they "would rather pay for online content in exchange for not being exposed to advertisements" increased from 30% to 35%. While younger cohorts are more relaxed about use of personal information in general, over a third (36%) of Australian survey respondents expressed some concern about their social networking posts/tweets being used for advertising or promotion purposes.

Most of the potential from big data analytics goes untapped, not simply because organisations have not put information online at data.gov.au – many agencies are not collecting great data; and the most innovative mash-ups have not been invented yet. Sometimes, even the prize-winners from 'hackathon' days go undeveloped or not commercialised after the event. We are not at the stage of listing what spreadsheets have to be transferred from our regulators websites to data.gov.au. However, consider:

- Australia could do with a better system of keeping data up to date. The latest data is on the website of apra.gov.au, but it hasn't been kept up to date on data.gov.au (it looks three years old).
- There are benefits from more location-specific data, rather than just national data repeats. For example, the addresses of bank branches or ATMs, could be stored so that online maps could locate them for consumers.
- Some location-based information about insurance claims might be of value for insurers or disaster management agencies.

Privacy regulation should be focused on informing and empowering consumers, not lots of rules. Improve data.gov.au by regularly updating data, having more location-specific assets and more information about insurance.

[58] Deloitte (2014) *Media Consumer Survey 2014*

11.2.2 Data security and cloud technology

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

- Implement mandatory data breach notifications to affected individuals and the Australian Government agency with relevant responsibility under privacy laws.
- Communicate to APRA continuing industry support for a principles-based approach to setting cloud computing requirements and the need to consider the benefits of the technology as well as the risks.

As the GFC demonstrated, confidence is crucial to well-functioning financial systems. Without confidence, capital markets ground to a halt. Consequently, with respect to data security, mandatory breach notification would help maintain stakeholders' trust in the integrity of the financial system.

Regarding specific cloud-based standards, it is important to have a baseline controls framework against which cloud providers can be assessed, based on the services they provide. Principle-based cloud computing requirements are fine, but when a cloud service becomes a size where they could cause systemic risk, there is a need to go beyond principle based cloud computing. Rather than covering this in existing PPGs, APRA should introduce a new PPG specifically on cloud, which should become the defacto standard for banks to use when considering a move to cloud.

Mandatory breach notification is important for trust.

Cloud needs baseline controls which are reviewed regularly as the technology (and its associated security) is expected to change dramatically.

11.3 Security

11.3.1 Cyber security

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

Review and update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation and progress public–private sector collaboration.

The Inquiry seeks further information on the following areas:

- Would a private–public sector discussion forum for strategic issues, such as cyber crisis planning, improve cohesion in implementing cyber security policy? What other mechanisms might assist to improve cohesion or coordination?
- Is there a need for more cross-sectoral or transnational mechanisms for information sharing, or for Government to work with industry to initiate the development of a collaborative model similar to the United States FS-ISAC?
- How useful would a voluntary cyber security framework, similar to that of the United States NIST, be in assisting industry to develop cyber capabilities?

Deloitte comments:

Deloitte agrees that the 2009 Cyber Security Strategy should be updated. The Security Strategy should provide for a consistent, streamlined and overarching set of principles to sit above and be informed by existing operational charters. The stated objective is to improve cyber-security risk management and collaboration across the public and private sectors.

We agree with the Interim Report's view that most companies and government entities take a tactical / operational view of cyber-security. To help facilitate a strategic focus, a key Security Strategy principle should be to facilitate the inclusion of cyber-security planning, readiness, and monitoring at a senior executive level. In addition, the Security Strategy should consider potential future industry and economic scenarios which would inform the security principles.

Private-Public Discussion Forum – Provided there was active participation from within and outside the industry, there would be value in a facilitated discussion forum. Areas of discussion could include details of emerging threats, practices on incident management and response, integration of security technology tools to business processes, and practices on assess cyber security capabilities While various informal discussions between and among the banks already occur, and facilitated discussions are held by various independent associations (the Big 4 professional services firms, Information Systems Audit and Control Association (ISACA) etc.), there is no formalised discussion forum with a sufficiently broad and structured remit to cover cyber-security involving the entire industry and relevant government players. By fostering meaningful information sharing, the implementation of such a discussion forum would benefit the smaller industry players, who currently don't have a 'seat at the top table' in discussions among the banks.

This would also benefit new entrants into the market who are not currently part of informal networks. In addition, there would also be benefit in including major third party cloud and outsourced service providers in the discussion forum.

Sharing of information and cyber security assets While the sharing of information undoubtedly occurs, for example by utilising external threat intelligence feeds, working with third party providers, and participation in various local and trans-national security fora, it is on a purely voluntary basis and does not divulge specific cyber-incident details. Without the existence of mandatory breach notification (see Section 11.2.2), there is a disincentive for financial institutions to share details of successful security incidents as they can have a material impact on company reputation and valuation.

In Australian financial services, the current situation impacts the smaller financial institutions (FIs) the most; they have had lower capital allocations and few operational resources focused on cyber security, resulting in a lower maturity of their cyber security capabilities. The Australian Cyber Security Centre (ACSC) should serve as an important consolidator and dispenser of cyber threat and incident information; however it will not necessarily get full input on security events from the private sector.

This issue extends beyond Australian FIs and so needs to be extended to include global and transnational service providers which have a material impact on the Australia economy and markets including, for example, cloud infrastructure providers, IT outsourcers, and business process outsourcers.

The incentive for Australian FIs is clear: by participating they get a more comprehensive view of the cyber security threats and, (as per Financial Services Information Sharing and Analysis Centre (FS-ISAC)), they get security alerts when a new threat is reported.

Australia needs to establish a standard and underpinning mechanism for cyber threat and security threat event information sharing across all of Australia business and government. The importance of this is growing as banks, insurers, and other FIs as well as other industries increasingly embrace the digital revolution, potentially raising the level of cyber security risk. The sharing mechanism should ensure confidentiality to avoid impact to individual companies.

Each of the major Australian banks is spending significant amounts of money on cyber-security detection and response capabilities. The industry could think more broadly than information sharing to consider a formal pooling of resources and potentially an industry-wide shared capability to better leverage both capital and scarce cyber-security resources.

An FS-industry owned and government-regulated security operations utility should be considered for feasibility and to determine whether it could contribute to raising cyber-security capabilities and maturity across the sector. The systemic benefits can be especially significant in improving the cyber security capabilities of the medium and smaller FIs, who may have under-invested in the cyber security technologies and processes required to adequately protect their information assets.

In the same way this would benefit new entrants into the Australian financial services market, for example superannuation or other, non-FS players expanding into banking, or foreign entrants.

In the event of another global long tail recessionary crisis, a pooling of investment and information would have systemic benefits, given that individual players would necessarily have lower levels of capital to invest in cyber security.

Single Cyber-Security Standard – Deloitte believes the implementation of a national cyber-security standard would provide Australian organisations with a common and pragmatic measure of current and planned cyber security capabilities and maturity.

The purpose of the cyber-security standard would be to help organisations to understand what they currently have in terms of capabilities, what they need to have as informed by the organisational context and risk appetite, and how they get from where they are to where they want to be.

The standard should provide a common terminology and descriptors to allow all organisations to baseline their capabilities and provide for meaningful benchmarking across industry.

To facilitate the wide adoption of the standard across industry, it could include tiering of recommendations based on risk appetite and organisational size and profile. The standard would be analogous to the National Institute of Standards and Technology (NIST) "Framework for Improving Critical Infrastructure Cybersecurity" and would seek to be informed by the various existing security controls.

We see no practical reason why Australia could not broadly adopt the NIST framework as it exists, removing the areas of US-bias (mainly around the privacy area) and rolling it out for use as a common standard for security. This would align Australia with the biggest security market, allow for global commonality of language and objectives, and save Australia the time and cost of separately building such a framework for ourselves. A further advantage of adopting a standard in alignment with NIST would be in allowing Australian organisations to assess their high-risk third-party (e.g., cloud) service providers against the same standard which they use to assess themselves.

Deloitte must stress that *compliance does not equal protection*, and that a risk-based capability assessment is more applicable to the real world of security than a certification of compliance with a controls framework.

The Security Strategy should be updated.

There is value in a facilitated discussion forum. Australia needs to establish a standard and underpinning mechanism for cyber-threat and security event information sharing across all of Australia business and government, and also including high risk cloud and other outsourced services providers.

The implementation of a national cyber-security standard would provide Australian organisations with a common and pragmatic measure of current and planned cyber security capabilities and maturity.

11.3.2 Digital identity

> **The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:**
>
> Develop a national strategy for promoting trusted digital identities, in consultation with financial institutions and other stakeholders.
>
> The Inquiry seeks further information on the following areas:
>
> - In developing a national strategy, what should be the respective roles, responsibilities and expectations of Australian public and private sector organisations in creating, accepting and maintaining the digital identities used by Australians?
> - Is there a need for Government to enhance identity authentication by facilitating interoperability standards in areas such as biometrics, enabling better access to Government information or improvements to the Documentation Verification Service?

Deloitte comments:

Identity and Customer Authentication – There is a clear market need for an independent mechanism to verify the authenticity of a person, particularly online. To that end, Deloitte favours a policy that aids in making this a priority and also promotes the development of standards, yet leaving the private world to define how best to develop this service in a way that is economic for the parties involved. As we have seen in payments, the most robust and risk-free solution may not necessarily be the best one as it imposes other costs to the network (e.g. three factor authentication would eliminate fraud but it would slow down transactions at the till), so a real understanding of the benefits, must be carefully weighed against the processing impost, including the ease of onboarding customers to such an authentication service.

The banking system has eradicated the very weak signature based authentication for credit card transactions. However, only high-value transaction users get strong authentication tokens, as each bank carries its own infrastructure.

The Banking sector already pays for several strong authentication mechanisms, and a consolidation of all these fragmented solutions may reduce costs, with coverage for all account owners in Australia.

In addition to securing financial transactions, the credentials could also be used to unlock Government digital certificates for legally binding documents.

With a little work, **social networks** have the potential to be as valuable in confirming an identity as a passport. It is the power of the crowd that can prove the integrity of the account holder, perhaps best described as crowdsourcing identity.

There are usually two goals of identity. The first is to confirm that ‘you are you who you say you are’ and the second, is to work out your relationship to other people.

Social networks can solve both. We are all familiar with the burgeoning number of websites that allow you to "login" with Facebook, LinkedIn or Twitter. The vast majority, though, are simply using a convenient approach to challenge and permit access. Rather than maintaining a new set of credentials, they are using a mechanism that maintains those sensitive details externally.

In past decades, our grandparents carefully checked the telephone directory when it came out to make sure all their family and friends were listed correctly. With the whole city doing the same thing, any mistakes (or even deliberate fraudsters) were pretty quickly uncovered.

Today, phone directories are barely looked at and are, at best, incomplete. Once you get through an ID check, your details are entirely within your control and very likely to go unchallenged.

Social networks are different. While the profile that is created is self-regulated, its exposure to friends forces a level of honesty. It may be easy to create a false identity, but a profile that is fully connected with the network and is actively maintained is much harder to fake for an extended period. Some of the things to look for include: levels of activity, numbers of "friends" or connections who are themselves active and connected, cross-posting and the amount of detail on the profile.

Credentials that aren't shared – Just as people will grab their smartphone before almost any other possession in an emergency, it seems that they value their social media login credentials above almost any other password.

People will often happily give out their credentials for video streaming services (such as Netflix). They allow their trusted family members to use their banking user details. They will even allow support staff at work to have their network password. But ask for access to their Facebook or LinkedIn account and they will refuse as it sits at the centre of their trusted friend network. Access to this core is just too sensitive to share.

In the future we could see building security where you "login with Facebook" and banks using social media credentials as part of identifying a customer when creating a new account.

A fair exchange of value – Whether a business or government service, it is important that the consumer or citizen receives fair value for using social media to identify themselves. The key is full disclosure.

If all that the Google, Facebook, Twitter or LinkedIn account is doing is providing access then the exchange is one of convenience. For the user, there is one less password to maintain and the site owner there is one less point of exposure.

However, it may be that the site or service needs to know about relationships, locations or other details which are maintained in the service. Full disclosure allows the user to feel confident on what is being used and why. If the use is appropriate to the user's needs then this approach provides a way of updating their personal details without the need to fill out as many forms.

Many online services need not have any username or password data at all and those that do may only need it for those customers or citizens who want to opt-out of the social media revolution. Arguably, this last group maintain less of their details online and are usually less exposed in the event of security breach.

Good practice suggests that there are economic benefits from using social media as part of an identity service rather than government or business trying to create yet another master, standalone, identity solution of their own.

In some North European countries settlement of transactions between businesses are both traceable down to the business legal entity and to the officer handling the transaction on behalf of the business. This highly reliable payment processing has been part of **helping governments implement document automation**, with full digitisation, as the digital credential used to authorise payments also can be used to digitally sign the documents that represent – say – a legal transfer of ownership of a vehicle.

With immediate / same day settlement of payments, the Government of Norway offers using BankID, Buypass (=Post ID) and two forms of Government ID to unlock Government issued digital certificates for signing documents with equal legal binding as ink on paper.[59]

There is a clear market need for an independent mechanism to verify the authenticity of person, particularly online. Social networks have the potential to be as valuable in confirming an identity as a passport. Whether a business or government service, it is important that the consumer or citizen receives fair value for using social media to identify themselves. The key is effective disclosure.

[59] See www.altinn.no for the document service, and www.brreg.no for insight into the public registrar service for looking up vehicle registration

Altinn (2008) About Altinn. https://www.altinn.no/en/Toppmeny/About-Altinn/.

Bregg (2014) About the Brønnøysund Register Centre. http://www.brreg.no/english/about.html.

12 International integration

12.1 Impediments to financial integration

The Inquiry seeks further information on the following areas:

- What are the potential impediments to integration, particularly their relative importance, and the benefits to the broader Australian economy that can be demonstrated if they were removed?
- Where is future Government engagement needed to facilitate integration with Asia?

Deloitte comments:

International financial integration, particularly with Asia, has grown rapidly in recent years. Regulations, international trade agreements and technological improvements have gone some way towards increasing Australia's cross-border participation in the financial markets. Australia has no entry restrictions or capital controls and has benefitted from a generally healthy foreign participation level.

However, cross-border activity is lagging behind its potential, with financial markets characterised by an overly domestic focus.[60] Despite Australia's many attractive qualities as a market for financial services, such as a skilled and mobile workforce, political stability, a sound legal and regulatory framework, one of the world's largest pools of funds under management, a strong banking system and world-class exchange infrastructure, international integration is limited by low brand recognition offshore and geographic remoteness from main financial centres in the UK, Europe and North America.

The Asian Funds Passport remains one of the best ways to unlock greater quantities of cross-border investment opportunities. In light of the success of UCTIS in Europe, there is a continued belief that the process of international harmonisation of financial regulations and mutual recognition of regulatory regimes provides a pathway for Australasian jurisdictions to develop a cross-border investment market. The value in proposals such as the Asian Funds Passport, is that recognition will be multilateral allowing for investment products to be structured to be compliant once, and then sold across a variety of different jurisdictions.

An obvious **impediment to international integration** is **ownership restrictions** – Australia's foreign investment framework. In order to encourage cross-border investments, it is imperative the Australian Government ensures regulatory frameworks governing foreign investment are not unduly restrictive or discouraging and are applied in a transparent and responsive manner.

[60] Australian Financial Centre Forum (2009) *Australia as a Financial Centre*. http://www.fex.com.au/media/AFCF.pdf

Ralston, D., Jenkinson, M. (2014) *International Linkages: Financial markets and technology*. Australian Centre for Financial Studies.

The Foreign Investment Review Board's power and independence should be strengthened to ensure decisions do not hinge on an individual's decision. At present the Foreign Investment Review Board's (FIRB) independence is limited by the fact that it is an advisory body only with a final decision remaining with the Commonwealth Treasurer.[61]

A prominent example of foreign investment policy restricting the financial integration is the rejection of the merger between the ASX Limited and Singapore Exchange Limited (SGX) in 2011.[62] The proposal had the potential for significant benefits for Australia, including building a conduit into Asian financial markets to improve financial flows between Australia and Asia, connecting Australia's funds management industry to fast-growing pools of Asian savings, raising the profile of Australia's financial markets within Asia, encouraging Asian capital to invest in Australia's economic potential and increased diversification across regions, markets and sectors to Australian savers and investors.[63]

Another clear impediment to international integration is **taxation**. Taxation arrangements differ significantly across jurisdictions and can impede competitiveness. For example, the Interim Report notes that the current application of withholding tax arising from clearing derivatives through a central clearing party is putting Australia at a disadvantage.

As mentioned in the Johnson Report, Australia's Tax System currently creates uncertainty around several key taxation related issues:

- what determines, for tax purposes, where an organisation carries on its business;
- what determines where it earns its income;
- what determines what type of income it is deemed to have earned, in particular whether that income is a capital gain or revenue; and
- the tax implications of where management decisions are taken.

At present many of these issues are determined according to common law principles which fit awkwardly with the demand from international investors **for clear, codified rules**. A greater understanding of Australia's regulatory structure could support Australia's ability to become a regional centre for wealth and investment management services. However, codifying trust law could have broader implications and raise significant concerns outside of investment funds. A similar outcome could be achieved through the creation or designation of special vehicles for cross-border investment products that addressed the aforementioned concerns.

Although it is clear that tax differentials are a priority for improving international integration, adjustments to the existing arrangements can have significant flow-on impacts. It can affect the tax balance domestically and influence behaviour. As such, it may be more appropriately considered as part of the Taxation White Paper.

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[61] Access Economics (2010) *ASX-SGX: why the combination is in Australia's national interest*, report prepared for ASX Limited.

[62] Swan, W. (2011) *Foreign Investment Decision.* http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/030.htm&pageID=003&min=wms&Year=&DocType

[63] Access Economics (2010) *Foreign Investment in Australia*, report prepared for the Business Council of Australia

Other impediments to international integration are outlined by the Interim Report:

- Costs and requirements associated with **licensing and ongoing compliance costs** being barriers to foreign entrants.

  Licensing and compliance costs in Australia can be significant, as discussed in Chapter 1. However, these generally apply equally to potential new entrants irrespective of whether they are foreign or domestic. As such, this is not a priority concern.

- Aspects of **prudential settings** in Australia having a **negative impact on international competitiveness**.

  Australia's current prudential settings exceed international standards, as discussed in previous chapters. This has a negative impact on international competitiveness, including for Australian institutions. It should be addressed as a priority, as outlined previously.

- Aspects of prudential setting in Australia and its inconsistency with supporting international expansion, such as **the way equity investments in offshore financial services businesses are treated for capital purposes**.

  International experience has shown that this can be a significant but challenging issue for regulators. In New Zealand, the Reserve Bank had legitimate concerns when it sought stand-alone capabilities. However, the proposed method of addressing these concerns was likely to be both costly and ineffective, pushing away overseas parents and thus resulting in increased risks. There are no clear-cut solutions.

  As such, although this is an issue which should be considered, it is a lower priority for the Financial Services Inquiry.

- Firms with transnational operations having difficulties in relation to **cross-border information flows**. For example, regulatory settings can impose requirements for record keeping that restrict data sharing across branches of the same financial institution located in different jurisdictions, acting as an impediment to cross-border activity.

  Firms may be required to collect different data, or data in different forms, across different jurisdictions. For instance, this might be required for tax purposes. Firms may also be subject to varying informational and privacy laws across jurisdictions.

  Some of these requirements (e.g. tax) are likely to persist. Thus, while it can be problematic, it is unlikely that this issue will ever be resolved in entirety.

- Lack of **access to some international concessional treatments and quotas for investment** that would be useful to Australian financial services businesses, such as access to China's RQFII program.

  It does not appear that this is a significant barrier to integration, or that this should be a priority area for further reform.

- **Anomalies between governance** requirements in Australia and some offshore jurisdictions that may place our companies at a competitive disadvantage.

  Anomalies between governance requirements between Australia and some offshore trading partners can be significant. There are continuing difficulties in establishing mutual recognition for supervision and governance. To some extent, this is being addressed by international standard setting schemes, including international accounting standards, and global economies following the lead of the US through the Sarbanes-Oxley Act (2002). However, Australia's biggest challenge will to establish trust between Australian regulators and Asian counterparts. This will require significant effort and time to address, and should be a priority.

Ralston points to a number of **other areas for government action**, such as **the removal of the withholding tax on non-resident deposits** (as recommended by both the Johnson Report and the Henry Tax Review) and **mutual recognition between jurisdictions to widen market access**. However, in comparison to foreign investment more broadly, these can be considered minor issues.

Other commonly cited impediments to international integration, such as differences in business practices and culture, were not identified as obstacles to international integration; e.g. Johnson does not mention these at all. Those differences were not considered to be 'showstoppers' and can be overcome through extensive business travel, employing employees with work experience, relocating staff with key management capabilities and sourcing employees locally.[64] However, as pointed out by Mike Smith, CEO of ANZ, when launching the Asia link Taskforce for an Asia Capable Workforce in September 2012, more could be done to assist integration:

> *"A number of number of critical individual and organisational competencies that are under-developed in Australia … and that are fast becoming an impediment to fully realising the Asia opportunity. The individual skills we urgently need more of include: sophisticated knowledge of Asian markets/environments; experience operating in Asia; and the ability to adapt behaviour to Asian cultural contexts."*

Benefits from removing impediments include a positive impact on economic growth through a larger pool of potential capital available to domestic firms, leading to increased demand for assets and a lower cost of capital. Financial integration also benefits an economy's productivity (by promoting both financial development and improved corporate governance) and investors (by reducing risk through increased diversification and the potential for higher returns due to increased investment opportunities).

> **Removing impediments will assist the flow of benefits from integration, especially by addressing ownership restrictions and increasing mutual recognition.**

[64] Deloitte Access Economics (2012) *Victorian Global Firms: Strategies for and Benefits of Internationalisation*, report prepared for the Victorian Department of Business and Innovation

12.2 Cross-border regulatory settings

> **The Inquiry would value views on the costs, benefits and trade-offs of the following policy option or other alternatives:**
>
> Improve domestic regulatory process to better consider international standards and foreign regulation — including processes for transparency and consultation about international standard implementation, and mutual recognition and equivalence assessment processes.
>
> The Inquiry seeks further information on the following areas:
>
> - What changes can be made to make implementing international standards more transparent and otherwise improved?
> - What improvements could be made to domestic regulatory process to have regard to foreign regulatory developments impacting Australia?
> - Are there priority jurisdictions and activities that might benefit from further mutual recognition or other arrangements? What are the identified costs and benefits that might accrue from such an arrangement?

Deloitte comments:

The Interim Report notes that the Australian financial system is increasingly affected by international standards and foreign regulation. This is likely to continue to increase over the next decade. The implementation of international standards in a domestic context results in trade-offs between global consistency and comparability, and domestic suitability.

Australia's robust regulatory regime is well-regarded internationally and helped protect our financial system during the GFC. The demonstrated effectiveness of regulatory outcomes in Australia reflects the legal framework, quality of supervision, and the effectiveness with which the regulations were enforced as well as the quality of regulation.

For integration, alignment with international regulations, rather than domestic regulatory standards, should be a starting point when new international standards are adopted in Australia unless there is a clear benefit from more conservative standards or faster implementation. Australia has much to gain from harmonised regulations: consistent regulations make it easier for companies to do business overseas and offers significant benefits to financial services firms operating internationally. However, the risk is that, if coordination and supervision are not tight enough, Australian firms are left exposed to global shocks. [65]

Extra-territorial legislation risks ending in conflicts caused by inconsistent foreign regulation. The government and Australian regulators should seek to influence foreign governments to avoid extraterritorial legislation wherever possible.

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[65] Charles River Associates (2005) *The RBNZ's Draft Outsourcing Policy*, Report prepared for the Australian Bankers' Association. (Internal Draft Document)

Ralston D, Jenkinson M (2014) *International Linkages: Financial markets and technology*. Australian Centre for Financial Studies.

Given the financial systems are increasingly connected, the principle of consistency is crucial in promoting financial system confidence and trust with key stakeholders.

An increase in international transactions and operations means that markets are no longer bound by geography. With an objective to insulate the Australian financial system from global shocks, regulators are now faced with the challenge of regulating cross-border operations in an effective manner that does neither restrict operations nor result in regulators losing control over functions overseas that affect the domestic economy.

In 2005, New Zealand – whose banking sector, with 98% foreign ownership, had significant exposure to foreign risks – responded to these issues by proposing an 'outsourcing policy' that required 'systemically important banks' to establish stand-alone capability in the event of their (foreign) parent or related parties suffering financial difficulty. Analysis of the proposal found that it would place significant restriction on the ability of banks to manage their operations in a cost effective and sound fashion and, rather than protect banks, increase the risk of financial stability due to a reduction in quality risk management practices across the group.[66]

A better alternative is to harmonise global regulation of financial markets, improve transparency and corporate governance, and increase cross-border cooperation by regulators (e.g. through establishing a reciprocal home country principle that provides oversight over a company's domestic operations and foreign branches, as done in the EU).

In the case of Australia and New Zealand, an agreement enabling closer cooperation at the supervisory level is already in place between APRA and RBNZ.[67] Such an approach of coordinated oversight of global institution is in line with Australia's current regulatory approach and allows regulators to best respond to market trends.

Ultimately, the extent of international integration will be shaped by ingrained **differences in business practices and culture.** For example, consider the case of a G-SIFI with substantial operations in Australia and in other countries in the region. It may not be possible easily to replicate the relationships between the various members of the Council of Financial Regulators that have contributed to the effectiveness of Australian prudential regulation, with their counterparts in other countries. This is one area where increased government engagement could prove fruitful, perhaps through secondments of senior regulators to the regulatory authorities in other countries.

Mutual recognition appears to offer a path to navigating cross border regulatory settings, subject to balancing the rule of law, regulation and supervision.

[66] Charles River Associates (2005) *The RBNZ's Draft Outsourcing Policy*, Report prepared for the Australian Bankers' Association. (Internal Draft Document)

[67] Australian Prudential Regulation Authority (APRA) & The Reserve Bank of New Zealand (RBNZ) (2012) *Memorandum of Understanding Concerning co-operation in banking and insurance supervision*. http://www.apra.gov.au/AboutAPRA/Documents/MoU%20RBNZ%20banking%20and%20insurance-May%202012.pdf

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Glossary, acronyms and abbreviations

ADI	Authorised Deposit Taking Institution
APRA	Australian Prudential Regulation Authority
ASF	Australian Securitisation Forum
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
BCBS	Basel Committee of Banking Supervision
CFR	Council of Financial Regulators
CLF	Committed liquidity facility
DAE	Deloitte Access Economics
EU	European Union
FCS	Financial Claims Scheme
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GLAC	Gone concern loss absorbing capacity
HHI	Hirschman-Herfindahl Index
HQLA	High quality liquid assets
IRB	Internal ratings-based
LMI	Lenders mortgage insurance
LTV	Loan-to-Value
LVR	Loan-to-value ratio
NFC	Near Field Communications
NPP	New Payments Platform
PDS	Product Disclosure Statement
PSB	Payments System Board
PSR	Payments System Regulator
RBA	Reserve Bank of Australia
RMBS	Residential mortgage-backed securities
SCCI	Specialist Credit Card Institutions
SIFI	Systemically Important Financial Institution

SME	Small and medium sized enterprises
SMSF	Self Managed Super Fund
UK	United Kingdom
VCLP	Venture Capital Limited Partnership

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