AFMA

AUSTRALIAN FINANCIAL MARKETS ASSOCIATION

Submission to the Financial System Inquiry

31 March 2014

AFMA

AFMA recognises the importance of efficient regulation to inspire investor confidence in our markets, and in this regard plays a leading role in providing industry input to government and regulators on public policy matters relevant to the financial markets. We seek to ensure that government regulation of the financial sector is firm enough to inspire investor confidence yet flexible enough to allow the markets to grow to their full potential. Official regulation is under-pinned by AFMA's conventions and other standards which promote best practice.

Promoting Market Professionalism

AFMA encourages high standards of professional conduct in financial markets by delivering professional development and accreditation programs to improve individual expertise in OTC and exchange-traded markets. AFMA accords accreditation, recognised by the markets regulator ASIC, to individuals who achieve the required levels of competence. AFMA provides training and accreditation for the staff of members engaged in the OTC markets and is a Registered Training Organisation.

Market Data and Documentation

AFMA administers and publishes the key BBSW benchmark rate and provides daily market data and documentation for OTC transactions to international standards. Further information is available at www.afma.com.au

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EXECUTIVE SUMMARY

The Financial System Inquiry (the Inquiry) is a well-timed check on the capacity of the financial system to meet the needs of businesses and households. The forward looking nature of the Inquiry gives it an important role in anticipating the financial services required to support our economy and in shaping the features of a financial system that will most effectively achieve this.

AFMA's submission to the Inquiry is based on three core propositions:

1. A strong economic performance by Australia is reliant on well-functioning wholesale banking and financial markets;
2. Well-functioning wholesale banking and financial markets depend in part on good regulation, which is the outcome of a capable regulator implementing an objective and well-substantiated government policy position – but as we explain below, it is now a more complex world and there is more to do in this area going forward; and
3. The financial system requires regulatory and tax policy settings that support its development, including by fostering innovation by industry participants – but we are not yet on the optimal pathway to achieve this.

The legislative focus of government has primarily been on how to regulate financial markets – not on how to grow them to meet the needs of the economy. Moreover, there has not been a clear strategic sense of how the Government in recent years wishes to see the financial system develop and what policies it will prioritise to achieve its objectives in this respect.

The consequent uncertainty introduces a difficulty for financial services firms who are preparing business plans that involve them committing capital to develop their business in Australia.

There needs to be a balance in regulation that is supportive of market development to meet the needs of the economy. This can be done within a framework that promotes financial stability and markets that are secure and fair.

The Inquiry's outcome should provide a basis for the Government to work with industry to prepare a strategic plan for the long term development of the financial services sector in Australia in a way that balances innovation, competition, stability, consumer protection and revenue-raising.

The Economy and the Financial System

1. The Financial Sector and Economic Growth

The financial system is an essential link in the chain of production that forms the national economy. A financial system that works well provides the basis for a successful economy but if it is inadequate, it will constrain economic growth and development.

Like the non-financial sectors of the economy, the financial system generates significant value within the economy and it does this by meeting the financial needs of business and households.

In other words, the core purpose of the financial system is to satisfy the demand for financial services from the non-financial economy (often called the 'real economy') and by doing so facilitate economic development and improve the welfare of Australians.

Key functions of the financial system include:

- Promoting the efficient use of economic capital by providing accurate price signals;
- Intermediating savings and investment;
- Allocating liquidity and risk within the economy; and
- Facilitating payments.

An efficient financial system improves national economic growth by:

- Minimising financial intermediation costs;
- Providing accurate price signals that drive the capital and risk allocation process and, thus, lift the productivity of the economy; and
- Increasing the amount of savings available for investment.

These relationships provide a sound foundation from which to judge the performance and potential of the financial system. It is these benefits that justify the absorption of scarce resources by the financial system.

Competent regulation of the financial system both improves its performance and the welfare of Australians as a whole. Achieving the right balance in financial regulation is an ongoing challenge and warrants attention at the highest level given the resources at stake.

The Financial System

The financial system is comprised of financial institutions (including banks, investment managers, insurance funds and superannuation entities), financial markets and the associated infrastructure required to support their activities. It is a complex and highly integrated organic system and needs to be regulated accordingly.

The equity and debt securities markets are a vital source of finance for companies, project developers, "nation building" infrastructure projects and financial intermediaries. Governments fund their fiscal position through debt and principally through the bond market. Efficient primary markets require secondary markets that are vibrant and function well.

The non-financial economy operates with less volatility and higher growth if financial prices are free to fluctuate in accordance with changing supply and demand conditions. Thus, there is a trade-off between the flexibility of key financial prices and the good performance of the economy. Derivatives markets support the real economy by providing an outlet for business and investors to hedge and trade risk arising from this financial price flexibility.

2. Performance of Australia's Financial Markets and Wholesale Banks

Australia's securities and derivatives markets have performed well in serving the economy since the time of the Wallis Financial System Inquiry, including throughout the Global Financial Crisis (GFC).

The equity capital market was an important ongoing source of finance to business and an essential backstop for funding during the GFC, when bank credit stalled. The proportion of equities trading on exchange increased markedly due to innovation and electronic trading.

The government bond market readily stepped up to provide government funding as the fiscal deficit expanded sharply during the GFC and has operated as a key piece of financial infrastructure, providing a risk-free yield curve, amongst other things.

The derivatives markets continue to evolve and have grown steadily over the period, with significant advance being made in managing the associated operational and systemic risks. Transactions costs declined due to market and product innovations, reducing the cost for business to hedge their financial exposures. For instance, energy derivatives complement the national electricity market, which has helped provide greater price stability.

The wholesale banking and financial markets are highly competitive, with a good spread of participants in each. Financial markets compete with banks by offering alternative funding and risk management arrangements to business but they also operate in a closely integrated manner with banks that provide liquidity in the markets and use them to raise funds and manage risk.

Competition in the provision of infrastructure for trading and clearing of financial transactions is uneven across markets. For example, the entry of Chi-X has introduced competition for exchange trading of cash equities and there is competition for clearing OTC interest rate swaps. Cash equities clearing and settlement is not yet open to competition.

Our financial markets and banking system did not suffer the systemic disruption and losses of the US and European systems during the GFC. This is the outcome of effective regulation, sound market practices and good business management, amongst other things. However, given the globalised nature of markets, the GFC had flow-on effects in the form of changing structures and regulatory reforms that increased the cost of financial intermediation.

Some notable market developments post the GFC include:

- The short term money market contracted as banks lengthened their funding maturity;
- Declining turnover, compression of commissions and new regulatory costs placed pressure on equity brokers;
- Banks' share of financial system assets increased; and
- Foreign banks' market share fell by about half, mainly because European banks reduced assets while Asian banks are growing from a small base.

A substantial wave of new regulation across the financial system in response to the GFC has increased regulatory costs for banks, market operators, stockbrokers, advisers, lenders, product issuers, market makers and traders. This process is incomplete as the transition process is ongoing and new regulatory costs are still emerging.

3. Drivers of Change in the Financial System

A major challenge for the Inquiry is to try to envisage the likely future shape of the financial system.

The first step is to consider changes in the structure of the real economy and how this might shape demand for financial services. Relevant factors in this regard include:

- Demographic change – affects the size and pattern over time of superannuation savings;
- The "Asian century" – drives the need for regional financial market integration, offers new funding sources and provides the opportunity for financial services exports; and
- The infrastructure investment gap – requires market-based long term funding solutions.

The capacity of the financial system to respond to these changes will depend on factors like:

- IT and technological developments;
- Regulation;
- Product and infrastructure development; and
- Competitiveness of Australia as a location for finance industry businesses.

Financial innovation will be required across a range of areas to enable the market to meet the investment needs of superannuation funds, the funding needs of business and the long term capital requirements of infrastructure projects.

Taking on board these factors, there is likely to be a structural shift to market-based financing.

The future success of the financial system in adapting to this change will depend to a great extent on how well its participants use technology and other resources to adapt to the changing conditions. This will involve uncertainties and challenges.

To address these issues;

- **Government** mandates to financial regulators should require them to have regard to the dynamic development of the financial system and to facilitate competition and innovation in their decisions and actions,
- **Regulators** should maintain the requisite skill set to respond to innovation and promote a culture within their organisation that supports a well-balanced response to innovation,
- **Industry** should develop best practice guidance and good risk management practices in relation to new products and services, educate stakeholders on the nature of innovations and give measured commentary on market innovations.

Policy Making and Regulation for the Financial System

4. Policy and Domestic Financial Regulation

The financial sector needs policies that are designed and implemented to produce the desired outcomes for the economy in a cost-effective and efficient way. Reforms that address market failures and raise the quality of supervision without undue regulatory burden contribute to growth in productivity, employment and income.

The complexity of a modern financial system means that Parliamentarians face a daunting task in grappling with policy development in relation to the financial products, institutions and markets. The only effective response is for legislators to maintain their policy-making authority and ensure that they have access to highly capable and objective policy advice to understand the implications of the laws they are making.

Good Treasury Policy Advice is Essential in a Complex Financial System

Frameworks for assessing whether regulation in an area is necessary or appropriate should be a key part of any government's policy framework. The principles of good regulatory process set out in "Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business" by the Federal Government in 2006 provide a sound basis for forming good regulatory policy. It also requires an effective management and organisational capability to ensure these principles are satisfied. However, Australia's policy-making ability in relation to the financial system has weakened to a degree in recent years.

The capability of the Department of the Treasury (Treasury) has been reduced due to budgetary constraints. This can lead to undue reliance being placed on the resources and experience of the tax administrators and regulators in the formulation of policy and design of associated law, even though these agencies are themselves important stakeholders in the policy process. The pressure on Treasury resources also causes delays in tax and regulatory matters being given appropriate policy attention.

It is important to retain an intellectually strong and well-resourced policy-making capability that is able to take a strategic top down, objective approach to financial system oversight and law reform. The Government needs to give attention to the current deficiency in its future planning for the capacity of the financial system.

It is necessary that there be coordination of the financial sector regulators under a process that provides for coherent and integrated policy guidance to them. The Government could consider giving the role of Chair of the Council of Financial Regulators to Treasury to provide core policy coordination of the financial sector regulators.

The Role of Regulators

The administrative role of regulators is separate to the policy-making role of Treasury and this distinction is necessary both for good policy development and the effective administration of policy measures.

Regulators should be independent to administer the law in accordance with government policy, free of corrupting influences and bias when dealing with individual regulated entities and business interests. However, responsibility for setting policy should reside in the Government and Treasury process.

Nevertheless, delegation of detailed rule-making authority to a regulator is necessary because no strategic policy-maker can foresee all policy issues that might be encountered in practice. Delegation of authority to regulators is also a pragmatic way to deal with complex issues.

The difficulty of this situation is the risk of ‘mission creep’, as regulators relying on their delegated rule-making powers may seek to extend the law beyond the original intentions of political policy-makers. Accordingly, the delegation must be done in a way to manage this risk and regulators must be given clear direction by government in relation to policy priorities.

Regulators should be assisted by having clearly defined roles and statements on what they are expected to do within the terms of government policy. Statements of Expectations by the Government to regulators, and their response through Statements of Intent should be regularly reviewed, perhaps on an annual basis.

The OECD[1] has recommended that regulatory agencies should be subject to independent review of regulatory decisions especially those that have significant economic impacts on regulated parties. The Uhrig Report[2] proposed that an Inspector General of Regulation be established to review, independently, a regulatory authority’s systems and procedures for the administration of legislation. There is merit now in examining the idea of creating an Inspector General of Financial Regulation to review the work of the financial sector regulators.

[1] OECD, Recommendation of the Council of the OECD on Regulatory Policy and Governance, 2012, p28
[2] Review of the Corporate Governance of Statutory Authorities and Office, 2002

Industry Input to Regulation

Without enlisting the industry's meaningful and active participation in the regulatory process, regulation will fall behind the dynamic nature of the market and market participants to move forward and innovate. AFMA supports market-based solutions as sound mechanisms to create efficient outcomes for governments and societies across a wide range of activities. Such solutions include industry best practice guidance and self-regulation, which has played an important role in the development of many financial services sectors.

Industry involvement in the regulatory process, including through self-regulation in appropriate cases, should form part of the future regulatory fabric of the Australian financial system. This has the capacity to improve market efficiency, give better regulatory outcomes and reduce the cost of regulation for business.

Regulatory Burden and Cost Recovery

The significant recent growth in cost recovery from the industry and the absence of rigour and discipline in the policy and practical basis upon which this is determined is a matter of concern from a financial system efficiency perspective. The last decade has seen a significant increase in the number and amount of fees, charges and levies imposed on financial institutions. The process has been ad hoc and lacked consistency and coordination.

It is often market intermediaries, not the 'beneficiaries' of the regulation, who bear much of the cost recovery burden; such is the case with cost recovery for AUSTRAC and market supervision by ASIC. The Government itself is often a significant beneficiary from regulation; for example, through higher tax receipts.

Cost recovery for regulation presents a significant 'moral hazard' for government because the incentive to have proportionate and efficient government regulation is diminished by the fact that government itself does not have to pay for this regulation.

The Government needs to introduce a coherent policy framework to determine if a cost recovery charge has a sound economic basis and, if so, ensure that it sits within a coordinated policy framework that takes into account the economy-wide impact of multiple service charges.

5. Australian Financial Regulation in a Global Context

International standard setting bodies have a major influence on the rules of the global financial system, and in turn national financial system policy. Australia, as a stakeholder in this process, needs assurance that their governance and accountability structures are satisfactory from a political economy perspective.

The arrangements for governance of international standard setters should be guided by the same principles of transparency, predictability, participation, reasoned and timely decision-making and accountability as are applicable to jurisdiction-based regulators. The Australian Government should discuss with other governments the broader issue of policy governance and ensure political legitimacy for the actions of global standard setters.

The important issue from an industry perspective is that the implementation of global objectives allows financial institutions to provide services to meet the economy's evolving needs and does not introduce distortions which send financial market activity off into unproductive activities. In this regard, the industry needs a globally consistent approach to the standards and rules that apply to it.

Australia should have the policies and processes in place to protect our national interest in these fora. Australian regulators should continue to be active participants in international standard setting bodies, so we are influential insiders in their decision-making processes. Our experience is that this can produce improved outcomes for Australia. In this capacity, regulators step beyond their narrow interest as an administrative body and have to argue for the broader policy objectives of the Government and economy.

Proposals to adopt international norms should require as much scrutiny and analysis as occurs in the domestic policy development process. In this regard, Australian policy-makers and regulators should make decisions and confidently utilise national discretion features as necessary to serve the interests of our financial system and economy, including the international competitiveness of its participants.

The ongoing development of Asian financial markets is important to support future economic growth in the region. Australia has a common interest with Asian countries in ensuring that the global financial standards are appropriate to the region. It is important that an Asian perspective be taken into account in bodies like the Financial Stability Board and the Basel Committee.

6. Taxation Policy and the Financial System

Taxation is an important component of the financial system, insofar as tax settings can drive, and potentially distort, the allocation of capital within the financial system and increase financial intermediation costs. Further, taxation policies directly affect the international competitiveness of the financial system and the extent to which Australia can attract foreign mobile capital.

The Inquiry should suggest that the Government should strike a balance between taxation and regulation policy that attaches priority to the future development of the financial system and adopt a coordinated, whole of government approach to policy implementation by its agencies.

In pursuit of this approach the Inquiry should:

- Articulate a principle to the Tax Reform White Paper process that the taxation treatment of returns from different assets classes should be consistent;
- Recommend the abolition of interest withholding tax from financial institutions that operate in Australia;
- Request that the Government provide a statement of support for the Offshore Banking Unit regime and facilitate bi-partisan support for the regime.

Developing the Financial System

7. Wholesale Banking and Financial Markets

The Government should work in conjunction with the industry to develop a strategic plan to develop the financial services sector in Australia in a way that balances innovation, competition, regulation/consumer protection and revenue raising.

In conducting this work, it is important that the principle of regulatory and policy neutrality between different products and different providers is applied diligently.

There is a strong desire for policy that provides the level of stability, consistency and certainty required for market participants to make decisions about the long term commitment of capital and other resources to their business in Australia. The Government should have in place long term, integrated policy settings that will give business certainty for planning and facilitate the further development of the financial system.

8. The Corporate Bond Market

A well-developed corporate bond market has a significant number of benefits for the funding and financial stability of the economy and for its various participants. For instance, it provides an efficient, flexible and safe mechanism to connect investors and borrowers, provides business with an additional source of funding, offers savers diversification benefits and may free up bank balance sheets, while enhancing competition in the financial system.

However, there are a number of significant impediments to development of the market:

- The costs for issuers and the impact of local regulations for corporate borrowers have restricted their capacity to issue into the market;
- An equity-bias amongst wholesale investors, and a focus on benchmark performance;
- Taxation outcomes relative to other asset classes;
- Lack of access for retail investors for most corporate issues; and
- Lack of education of retail investors.

Initiatives that might assist in the development of the corporate bond market and should be considered include ensuring that:

- It is no more onerous for corporate borrowers to raise funds via the Australian corporate bond markets, both wholesale and retail, than other sources, including the Australian equity market, bank financing and offshore debt markets;
- Investors, particularly retail, have adequate access and greater choice; and
- Investors, both wholesale and retail, have the necessary skills and knowledge required to recognise the importance and benefits of corporate bonds in their portfolio, particularly in the context of an aging population.

9. Retail Financial Markets

The structure of the retail investment industry is changing as a result of the GFC and domestic events, and because of the changing demographic of retail investors including their growing inclination to receive information and advice about investments through technological innovation rather than more traditional advice models.

At the same time, the cost of compliance and providing financial services is continuing to increase, and Australia is moving towards being at a competitive disadvantage compared to other centres that are able to provide services to Australian investors.

Several areas of retail regulation that are suitable for review are:

- The ongoing usefulness of the disclosure regime in its current form;
- The effectiveness of the licensing regime as a mechanism to ensure high standards of conduct by persons who provide financial services;
- The current predilection of regulators to try to impose additional obligations on industry participants above and beyond statutory obligations;
- The way in which regulatory resources are allocated to supervision of risk areas; and
- The completion of the review of the distinction between retail and wholesale investors in the legislation, commenced by the previous Government in 2012.

10. Industry Standards and Professionalism

The effective operation of the financial system is dependent on the competence of participants and trust in their capacity to provide their services in a secure and fair way.

AFMA supports the consideration of a broad framework for promotion of industry standards of competence and professionalism in the provision of retail financial services that benefits licensees and their representatives, as well as consumers.

The delineation between retail and wholesale clients should be preserved as a cornerstone of financial regulation and, in this context, government should work with the financial services sector to support an industry-based approach to professionalism in the wholesale market.

11. Australia as a Location for Financial Services Businesses

The income and employment benefits of the financial services industry provide a strong incentive for the Government to ensure that as much of this activity as possible takes place in Australia.

This will not be easily achieved, as there is significant competition for mobile financial services business in the Asia Pacific region, with centres like Singapore having highly developed and supported policy programs to attract business to their financial centres.

Steps that should be taken towards lifting our international competitiveness include:

- A firm commitment by the Government that it will give a high priority to measures necessary to sustain an internationally competitive financial sector and communicate this, together with expectations and targets, to its relevant agencies;
- A Treasury Minister being given responsibility to champion Australia as a financial services centre, both within government and externally and to work with State counterparts to coordinate policies to promote Australia's financial sector; and
- Implementation of the regulatory and tax measures recommended in the Johnson Report and examination of other measures since sought by industry to improve Australia's competitiveness.

SECTION 1 – The Financial Sector and Economic Growth

KEY POINTS

- A strong economic performance by Australia is reliant on well-functioning wholesale banking and financial markets.
- The core purpose of the financial system is to satisfy the demand for financial services by the non-financial economy and, by doing so, facilitate economic development and improve the welfare of Australians.
- The financial system is a complex and highly integrated organic system in which both financial markets and wholesale banks play a key role.
- Financial markets are central to funding the economy and efficient primary markets require vibrant secondary markets that function well.
- Flexible financial prices provide for a more stable economy by helping to absorb shocks. Derivatives markets support the economy by providing an outlet for business and investors to hedge and trade risk arising from this financial price flexibility.
- Competent regulation of the financial system both improves its performance and the welfare of Australians as a whole.

1.1 A Successful Economy Needs an Effective Financial System

The financial system should serve the economy and society and its purpose is to facilitate economic development and improve the welfare of Australians.

The key economic challenge for Australians and their governments is how best to use the limited economic resources that are available to us. This involves decisions about the use to which our labour, capital and natural resources should be put. Good decisions enhance the productivity of the nation and increase our income and wealth and poor decisions leave us worse off. Australia has a market-based economy, which is widely accepted as the optimal way to achieve this purpose. The financial system, comprising financial institutions and markets, plays an integral role in this process through the allocation of capital to various activities within the economy, as explained in more detail below.

Markets are not all perfect and governments occasionally intervene in economic affairs both to support the effective functioning of markets and to counter the effect of market failures (ie the market for some reason does not efficiently allocate resources). Environmental and planning policies are examples of this.

The financial system is one of the most highly regulated sectors of the economy because many financial arrangements are characterised by information asymmetry and less financially sophisticated consumers of these services require protection. The financial sector is susceptible to systemic risk that could significantly disrupt the performance of the economy.

Competent regulation of the financial system both improves its performance and improves the welfare of Australians as a whole. Achieving the right balance in financial regulation is an ongoing challenge and warrants attention at the highest level given the resources at stake.

1.2 The Financial System and Economic Growth

Key functions of the financial system include:

- Promoting the efficient use of economic capital by providing accurate price signals;
- Intermediating savings and investment;
- Allocating liquidity and risk within the economy; and
- Facilitating payments.

The economic benefits from an efficient financial system are very substantial. For example, if business was restricted to self-finance, it would be a major constraint on project development. Similarly, the absence of liquidity or risk management facilities required by business in a modern economy would impose a severe cost on the economy.

The financial system absorbs costly economic resources to operate, so it is important that the correct balance is struck between the cost and benefits of the financial system. The allocation of the right level of resources to the financial sector is important to the economy. Under allocation would mean that the sector is less effective in meeting the needs of the real economy; resulting in a sub-optimal economic performance. Over allocation of resources would draw resources away from other productive activities and likewise diminish the economy's performance. This concept has important practical implications and can be illustrated formally as presented in Box 1.1.

BOX 1.1 – Financial Intermediation and Economic Growth

Financial intermediation involves the allocation and transfer of a range of things, like finance, risk and liquidity, between persons and entities in the economy. This enhances economic growth.

To illustrate this, the intermediation of saving and investment by financial institutions and markets can be represented by an identity like (1):

(1) $\mathbf{I = \dot{K} + \mu K = (1 - \varphi)*S}$ $1 > \varphi > 0.$

I is gross investment, S is saving and φ represents the cost of savings and investment intermediation. K is the capital stock, $\dot{K}$ is the change in K and μ is the depreciation rate.

The closer φ is to zero, the more efficient the financial system is. The higher is φ, the greater is the amount of resources absorbed by the financial sector, for a given level of financial intermediation.

The link between economic growth and financial sector development is neatly demonstrated within a standard economic framework. Assume $Y = AK$ (a simple linear production function for output Y, a homogeneous good) and a stationary population. The coefficient A represents the productivity of capital (K) and captures the effect of technological development (including that applied in the allocation of resources). This can be interpreted as an endogenous growth process. Introducing saving-investment intermediation costs, as in (1), yields a long run growth rate (g) of:

(2) $\boldsymbol{g = A(1 - \varphi)S/Y - \mu}$

From (2), it is clear that economic growth is:

- Negatively related to financial intermediation costs (φ);
- Positively related to capital productivity (A); and
- Positively related to the savings rate (S/Y).

These factors are interrelated. For example, lower financial intermediation costs help to smooth the capital allocation process within the economy, which lifts productivity.

The benefits of financial intermediation are not limited to financing but extend to other services, like the reduction in risk facing businesses. For instance, risk management may reduce the effective depreciation rate (μ), by preserving the value of the capital stock for longer than otherwise, in the face of external shocks.[3]

The level of financial intermediation in the economy should be set at the point where its marginal benefit (eg through financing) equals the associated marginal transaction cost.

[3] Consider the following example. An external shock generates a 25% appreciation in the exchange rate, making exporter *X* uncompetitive and its specialised capital stock valueless (that is, 100% immediate depreciation). A currency hedge preserves *X*'s competitiveness for a period and, therefore, the productiveness of its capital stock for the length of the hedge. It also provides time to adjust to the new exchange rate level, which may salvage some part of the capital stock. If the external shock is reversed within the period of the hedge, then the value of the capital stock is preserved beyond the period of the hedge. Either way, the effective rate of depreciation is reduced.

While care must be taken to avoid underestimating the sophistication and complexity of the financial system; the analysis presented in Box 1.1 is useful because it provides a simple framework to understand the economic importance of the financial system and to gauge its performance. In particular, it identifies core relationships and associated metrics to assess its performance and are, thus, highly relevant to the Inquiry. These are:

i. Financial intermediation costs;
ii. Price signalling and the effectiveness of the capital allocation process; and
iii. Funding the economy - generating adequate savings to support investment.

These indicators provide a framework that encapsulates the matters of central importance to the Inquiry and we return to them at relevant points throughout the submission, as they are relevant to the analysis and conclusions of the Inquiry.

1.3 The Operation of the Financial System

The operation of the financial system, including its internal processes and interactions, must be effective if it is to meet the needs of the economy in the optimal way. The outcome depends on a range of factors including competition, innovation and utilisation of technology, proportionate regulation, public confidence and resilience of the system, amongst other things. How well the financial system performs in this regard and how this might need to change as the economy itself changes are central considerations for the Inquiry. An assessment of these dynamic efficiency issues requires some elaboration on the workings of the financial system.

The financial system is comprised of financial institutions (financial system is comprised of financial institutions (including banks, investment managers, insurance funds and superannuation entities), financial markets and the associated infrastructure required to support their activities. These components operate in a tightly integrated manner; for instance, financial markets provide an essential mechanism for banks to raise funds used to provide loan finance to business and household clients. Financial markets also provide the capability for banks to transfer risk between themselves and accept risk from their clients. The efficiency of the financial system depends on how well this occurs in practice; both in terms of practical cohesion of the various types of operations within the system and through containment of systemic risk.

Banks are a critical feature of the financial system because of their role in funding the economy; principally by generating deposit savings and lending to business and households. Banks take advantage of distinctive economies of scale, undertake portfolio transformation[4] and provide essential liquidity to investors, while using their credit assessment and monitoring skills to overcome the effect of information asymmetry between savers and borrowers. Banks are distinguished by their high ratio of borrowed funds to equity and the trust placed in them by depositors, which is why they are subject to high intensity regulation.

[4] Substituting their own liabilities for those of the ultimate borrower, which also involves maturity transformation (ie a mismatch between the maturity profile of their assets and liabilities).

In contrast to banks, financial markets bring savers and borrowers directly together by enabling them to trade standard, marketable financial instruments. Thus, for example, the mechanisms to manage information asymmetry are different to banking and the parties involved have more direct responsibilities for themselves. Importantly, financial markets provide financing options, like equity funding, that are not available through banks and centralised risk management facilities (eg futures markets) that have greater depth than can be provided by individual banks. The operation of financial markets also generate a range of risks (eg that a counterparty may not make good their commitment) that are dealt with through both market rules and arrangements and also through regulation.

The intensity of financial market regulation has been markedly increased post the global financial crisis (GFC).

The degree of interconnectedness of a developed financial system like Australia's is extensive:

Pricing transmission

- Financial prices are highly interdependent; for example, a rise in money market interest rates will impact forward foreign exchange rates, the price of bonds through the discount rate used to value them, the cost of equity through the capital asset pricing model, which feeds into the weighted average cost of capital and ultimately into the net present value (NPV) of a real economy project, which will determine if it will proceed or not.
- Financial market pricing assists bank product pricing by providing benchmark interest rates or base rates for certain types of risk that accurately reflect economic conditions.

Wholesale to retail

- Households benefit from efficient wholesale markets – for example, the more efficiently a bank can raise funds on financial markets and manage the associated risks, then the more it can reduce the cost of finance to individuals.
- Households benefit from competition in the financial system – or example, term deposit investors received keener rates as banks competed for longer dated funds as they were required to lengthen their funding profile post the GFC.

Domestic to international

- Business gets access to international capital – the capital and foreign exchange markets provide an essential connection between pools of savings in different jurisdictions and facilitate the flow of investment funds between national economies. Global bank funding commitments to their Australian operations and cross border bank lending (eg through syndicated loan arrangements) are also a vital source of international funds to Australians.

An important take-away point from the interconnectedness of the financial system is that tinkering with a policy in one part of the system may have implications for other parts. Therefore, the assessment and judgement of policy proposals needs to explore and take account of the wider implications of change. Moreover, it is faulty to form such a conclusion on an individual policy or regulatory proposal without understanding how this might work in combination with other reforms being implemented or being contemplated.[5] These issues are discussed further in Section 4.

1.4 Economic Role of Financial Markets

The financial system services the end-users who are business, households and government. The economic purpose of dealings between financial services businesses is to improve the quality and cost effectiveness of financial services provided to end-users.

The economic role of financial markets (both securities and derivatives) needs to be understood in this context. The financial system as a whole would fail to meet the needs of the real economy in the absence of effective financial markets and the associated economic loss would be substantial. For example:

- The availability of loan finance to businesses and households would be greatly reduced;
- The cost of finance to business, households and government would be markedly higher, reducing the range of viable business investment options;
- Productivity would fall in the absence of reliable price signals to stimulate the optimal allocation of capital and risk within the economy;
- Risk within the economy would increase, deterring investment;
- Limiting the scope for implementing monetary policy
- Connectivity between the Australian economy and world markets would be disrupted; and
- The economy would become less competitive and unable to adjust effectively to international economic developments.

These examples reflect:

- The critical role of the capital and securities markets in providing finance to business and financial intermediaries;
- Competition between financial markets and institutions that lowers financial intermediation costs in the economy;
- Price signals that inform business and households in the choices they make both in relation to the amount of savings and investment they wish to undertake and the specific savings and investment vehicles they use for this purpose; and
- Greater economic integration between economies; financial markets facilitate the flow of capital between economies (ie they provide a cross border link to pools of savings) and enable the management of financial risks.

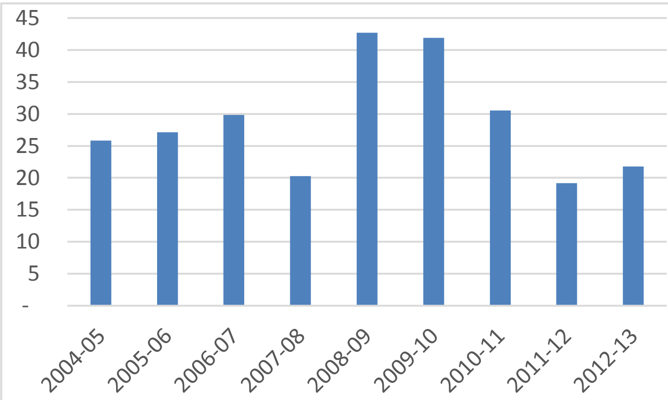
[5] By analogy, one medicine may fix a particular ailment and a second may fix another ailment but the combination of the two medicines may be harmful or even fatal for an individual.

1.4.1 Securities Markets

The securities markets are an important source of finance for companies and government. Companies and project developers, for "nation building" infrastructure projects, raise both debt and equity finance, with proportions dependent on a range of individual factors like the size and nature of their business. Government fund their fiscal position through debt and principally through the bond market.

Section 2 of this submission provides information on the context and scale of the securities markets. However, purely by way of illustration Figure 1.1 presents annual equity capital raising on the Australian Securities Exchange (ASX) as a percentage of approvals for large bank loans to give an indication of the relative importance of equity capital raising.

FIGURE 1.1 – ASX Equity Capital Raisings as a Percentage of Banks' New Credit Approvals



Note: Derived from published ASX and RBA statistics for loan approvals of $2 million and over.

The primary market is the place where an issuing entity (usually a company) raises new capital by selling their debt or equity securities to investors. The secondary market is where securities already issued are traded between investors.

Efficient primary markets require secondary markets that are vibrant and function well. The ongoing provision of price information through secondary markets is necessary to evaluate new security issues, while the liquidity they provide should enable investors to enter and exit positions in a quick and cost effective way as their investment preferences or other factors require a change in their portfolio.

An effective financial system depends on there being adequate competition within the system and financial markets add to diversity within the financial system in this respect.

Companies seeking to raise finance for investment may tap the equity market as an alternative to debt funding though bank loans or marketable securities. While the intrinsic properties of debt and equity are different, they are nonetheless imperfect substitutes that may have more or less relevance at different points in time. For example, the ability of listed companies to raise equity capital quickly during the GFC when debt markets were constrained was an important mechanism enabling many companies to reduce debt exposure and strengthen their balance sheets.

Corporate bonds share may characteristics with bank loans but they are not a perfect substitute for borrowers or investors; bank loan arrangements are more flexible than bonds but the latter are more readily tradeable. Nonetheless, they provide a welcome element of competitive tension within the system.

Another notable benefit of a well-diversified financial system is greater resilience and a reduction in systemic risk, assuming that there is proportionate regulation of the various subsectors. This eases the risk of the economy's over reliance on any particular segment of the financial system or overseas markets.

1.4.2 Price Signalling

Financial markets play an important role by bringing together issuers and investors and facilitating their interaction to put a value on a particular financial instrument. This plays an important role in the economy's capital allocation process, as projects that generate the highest economic returns will attract relatively more funds.

However, the information content of securities is not limited in application to the specific performance of companies or projects that are being financed through marketable instruments. For instance, a price change that reflects a revised market valuation of one firm may have implications for other firms in that industry. At a more macro level, the implied term structure of interest rates in the bond yield curve is proven to be a useful predictor of economic growth and inflation and contains important information about future economic performance, which is also useful in making investment decisions.

Some financial prices serve as a benchmark for other financial prices within the financial system. The most important benchmarks are generated from liquid markets with active pricing by multiple participants on a regular basis. This is an efficient form of price discovery within the financial system, as liquid markets are best placed to process new economic information and reflect this through appropriate price adjustments, which then gives a lead to pricing in other parts of the financial system.

Examples of benchmarks within this meaning include Commonwealth Government Securities (CGS) yields and the Bank Bill Swap (BBSW) rate that is published by AFMA. There are important practical differences in the way that these benchmarks work. In particular, the BBSW rate is regularly written into the legal contracts and derivatives contracts and has a very direct impact on pricing, while the CGS yield curve is the risk free-rate that is a foundational economic element in the pricing of many financial instruments but generally is not referred to directly in contracts.

BOX 1.2 – Government Bond Market

Government bond markets have much less information asymmetry than private sector debt markets and transaction costs are lower given the deep lines of issuance and liquidity of the market. Key attributes of CGS that make them unique are their high liquidity and they effectively embody no credit risk. Risk management products and private sector debt instruments depend on it for outright interest rate price discovery.

The specific role of financial markets in the financial system and the broader economy was a feature of the Government Review of the Commonwealth Government Securities market in 2002-03. This highlighted the role of financial markets as a source of cost effective finance for the Government (which became most evident following the GFC) but the critical importance of the risk management and price signaling functions of the market to the economy.

In particular, the Review concluded that, while financial markets may innovate in the absence of CGS, it was more likely that closing the CGS market would lead to slightly higher interest rates given the development of Australia's financial markets and current lack of effective alternatives to CGS.

This outcome would result primarily from the higher costs associated with managing interest rate risk without a Treasury bond futures market. Further, the Australian financial system may become less diversified and more vulnerable during periods of instability.

Financial markets provide a means to decompose the risk of an arrangement into its component parts, which is a process that delivers more efficient pricing and ultimately lower costs for borrowers. This is most evident in the operations of the derivatives markets.

1.4.3 Risk Management & Derivatives

The flexibility of liberalised interest and foreign exchange rates creates volatility in these prices but this provides for a smoother adjustment in the real economy to economic change and shocks. Derivatives markets, like securities markets, help to provide order within the financial system by providing an outlet to trade this financial price risk. Imbalances occur in the supply and demand for risk on an ongoing basis and it is the purpose of the market to facilitate exchange of risk so that the market establishes a price that restores equilibrium. This has important benefits for the real economy.

BOX 1.3 – Why the Economy Needs Risk Management Products, like Derivatives

The financial system should not be viewed in a narrow sense of being simply a funding vehicle for the real economy. This might have been appropriate decades ago, when the economy itself was relatively closed, less flexible, less competitive and more centrally controlled. Back then the economy had a smaller exposure to trade and global economies, the exchange rate was essentially fixed and key interest rates were centrally administered. A modern economy requires vibrant derivatives markets to manage the price volatility associated with a modern economy.

The origin of foreign exchange and derivatives markets of the scale seen today was a decisive movement to make the main global economies more open to international trade and investment, more sensitive to international competitiveness through flexible exchange rates and through financial deregulation. This had substantial economic benefits; for example, allowing interest rates to reflect economic conditions meant resources were allocated to more productive projects and investors were compensated for inflation and positive and more stable real interest rates promoted saving. However, enabling financial prices, like foreign exchange rates and interest rates, to reflect changing economic conditions necessarily meant that they became more volatile.

These reforms involving greater volatility of nominal financial prices were a spur to economic development but they also generated a need for companies, governments and financial intermediaries to manage the risks inherent in a flexible, modern economy. This stimulated the development over time of the foreign exchange and derivatives markets, as entities sought to reduce their risk to more volatile prices.

With this change came the regulatory challenge to ensure that the financial system fulfils this purpose in a cost-effective, secure and stable manner.

The capacity of companies to manage interest rate risk through derivatives and other financial products contributes to a lower cost of capital in Australia. For example, investors may accept a lower yield from a corporate bond if they believe they can efficiently hedge the interest rate risk associated with holding this bond. In addition, the ability of financial institutions to manage interest rate risks associated with their balance sheets may also contribute to lower costs for consumers on a range of products including retail loans.

In practical terms, the ability to efficiently manage risk at a reasonable cost is vitally important to corporations, as well as financial institutions. Australian markets are well advanced in this area and the range of effective, low cost, risk management options provides Australian companies with a competitive advantage over companies from jurisdictions with less developed markets.

BOX 1.4 – Hedging a Major Project

Take the example of a company that finances a large project or infrastructure investment through a floating rate loan from a bank and then enters with a swap with another financial institution to pay fixed interest and receive floating rate interest; in effect converting its floating rate loan into a fixed loan giving it greater certainty and lower risk. The cost of the swap will depend to a significant degree on the ability of the institution providing it to hedge the risk it has consequently taken on its books. Timeliness of hedging this risk matters, given market volatility, and hence risk to the institution is heightened, the longer the position is held open.

The Treasury bond futures market is highly liquid, so the institution can rapidly clear its associated outright interest rate risk (ie interest rate risk excluding credit risk) on a cost effective basis through the futures market and then manage the remaining risk (the difference between the swap and futures rates) over a longer timeline. Consequently, the lower is liquidity in the bond futures or swaps market, then the longer it will take to hedge risk and the more expensive it will be for the company to access fixed interest rate finance.

Thus, it is evident that financial markets both complement and compete with financial institutions. While they provide a venue for lenders to raise finance and manage risk, they also provide competition within the financial system by providing an alternative source of finance for Australian companies. Similarly, financial markets provide investment diversification opportunities for savers and essential tools to manage risk.

In summary, financial markets:

- Provide direct financing for government and business;
- Provide investment opportunities (including liquid assets);
- Emit price signals (micro and macro) necessary for effective capital allocation;
- Complement financial institutions;
- Provide competition in the financial system; and
- Support risk management products.

1.5 Financial Intermediation Costs

The performance of the economy is inversely related to the cost of financial intermediation. In simple terms, a lower cost for investing, raising funds or managing risk, in accordance with the needs of the economy, reflects a smaller demand by the financial system on our scarce economic resources. Of course, the demand for financial services is price sensitive, so lower financial intermediation costs will generate higher demand for this service. The economy’s market system will on balance determine the amount of financial services provided in the economy.

Important determinants of the cost of financial intermediation include:

- **Economic prices** – the price of labour, capital and other resources used by financial system providers.
- **Competition** – more intense competition drives out less efficient financial service providers and is a potent check on pricing behaviour by remaining providers.
- **Regulatory burden** – the financial system is perhaps the most heavily regulated sector of the economy, which imposes significant (and rapidly growing) compliance costs on providers. In addition, some financial market providers (like stockbrokers) incur large costs because the Government uses them as a convenient way to recover its cost of financial supervision.
- **Technology and innovation** – technological advances and business innovation can reduce the cost of providing financial services, especially in relation to the processing of large volumes of transactions.
- **Taxation** – the operational costs of the financial system include providers' corporate tax obligations as well as transaction costs (like interest withholding tax and GST) on their business operations.

The impact of each of these determinants is picked-up at relevant parts of the submission, with specific attention given to regulation and taxation in Sections 4 to 6. However, the high impost through more intense regulation of banks and financial markets, in response to the GFC, is particularly noteworthy at this point. The effects of this are being felt across the system through banks (eg Basel III capital and liquidity measures), over-the-counter (OTC) derivatives markets (notably central clearing and trade reporting) and exchange markets (eg the market supervision levy).

Containing the cost of financial intermediation is an important matter. For instance, an increase in the cost of transacting on financial markets would:

- Reduce asset prices – Investor returns are net of costs, so they would reduce the price they are willing to pay for a given security;
- Lessen liquidity – Investors would be less willing to trade if the cost of doing so increases;
- Harm price accuracy – Less frequent trading would result in securities prices drifting from fundamental values at times, as they are not being repriced as regularly;
- Cause price volatility – More thinly traded markets could lead to price volatility as standard trades are harder to achieve without price impact.

Therefore, it is evident that a rise in financial intermediation costs would affect the economy directly through the resources it absorbs form the real economy but it could also affect the effectiveness of the financial system as a whole in meeting the price signalling and other needs of the real economy. In terms of the relationship between the financial system and economic growth presented in Box 1.1, a rise in intermediation costs would reduce economic growth through all of the identified relationships.

SECTION 2 – Australia's Financial Markets and Wholesale Banking

KEY POINTS

- Australia's securities and derivatives markets performed well in serving the economy since the Wallis Financial System Inquiry, including throughout the GFC.
- A substantial wave of new regulation across the financial system in response to the GFC has markedly increased regulatory costs for banks, market operators, stockbrokers, advisers, lenders, product issuers, market makers and traders.
- The wholesale banking and financial markets are highly competitive, with a good spread of participants in each, but business conditions have been variable.
- Significant developments since the GFC include a large increase in the size of the government bond market, difficult business conditions for equities brokers and a marked contraction in the aggregate balance sheet of foreign banks.
- While new capital and liquidity standards have improved bank safety, the consequent constraint on bank trading inventories has reduced liquidity in some global markets; to some degree shifting risk to the issuers and investors who use the markets.

2.1. Introduction

The financial system is comprised of financial institutions, financial markets and the infrastructure that support them.

Financial markets are the medium through which capital and risk is transferred between participants in the economy. The debt and equity markets are of primary importance, given their role in funding the economy. Derivatives markets enable management of financial risk. There are two major market types in Australia: over-the-counter (OTC) and exchange-traded.

Wholesale banking focuses on the financing of large and medium sized businesses, governments and projects; for example, by arranging and underwriting syndicated loans and participating in public private partnerships to fund infrastructure investment. Wholesale banks are also key participants in the capital and derivatives markets; both to hedge their financial exposures and to service their clients (including through market making).

Therefore, wholesale banks and the financial markets offer competing funding and risk management arrangements to business but they also operate in a closely integrated manner.

This section outlines the key operating characteristics of the wholesale banking and financial markets and recent market developments.

2.2. Financial Markets

The OTC markets are substantially institutional markets, have a broad range of participants and are not dominated by any particular group of banks. The exchange-traded market services both institutional and retail investors and has a wider mix of participants.

Anecdotal and survey evidence supports the contention that Australia's financial markets are highly competitive. Table 2.1 provides market turnover data for key financial markets. No participants dominate and markets have a good spread of providers, with the market leaders varying from market to market. The GFC did not fundamentally alter this position, though some firms exited markets and others transferred traders to offshore locations.

Table 2.1 – Selected Financial Markets in 2012-13

Market	Market turnover ($ billion)	Market share held by each leading provider on average
Equities	1,151	10%
Government bonds	1,778	15%
Non-government bonds	777	20%
Repo	7,864	15%
Interest rate & cross currency swaps	10,495	15%
Overnight index swaps	8,894	15%
Forward rate agreements	5,937	17%

Note: Derived from data compiled for the Australian Financial Markets Report, AFMA and media reports. Market share data for leading providers is the average of the market share for the four largest providers in each market.

Competition in the provision of infrastructure for trading and clearing of financial transactions is uneven across markets. For example, the entry of Chi-X has introduced competition for exchange trading of cash equities and there is competition for clearing OTC interest rate swaps. Some other areas, like cash equities clearing and settlement, are not yet open to competition.

2.2.1. Operating Structures

Traditionally, financial products that are traded OTC have been those that are non-standardised, where terms and conditions were negotiated between the counterparties involved in the transaction. This provides greater flexibility in product design so the specific needs of clients can be met more precisely. OTC derivatives are a cost effective way to manage risk and they have evolved into liquid markets that often trade more actively than the physical markets that they are derived from.

In the post-GFC environment, OTC derivatives, particularly interest rate swaps and credit derivatives, have increasingly been subject to standardised terms as a means to ensure eligibility for central clearing as prescribed in many of the major jurisdictions.

TABLE 2.2 – Illustrative Economic Benefits of Key Financial Markets

Market	Price signalling/ Capital allocation	Savings	Financial intermediation costs	Financial System Infrastructure
MONEY MARKET				
Bank bill and Negotiable Certificates of Deposit market	Financial system benchmark for short term interest rates Short term funding mechanism for banks	Outlet for short term investment Flexibility to adjust terms as dictated by cash flows projections	Reduced - efficient intermediation mechanism	Supports risk management products Contractual benchmark short term interest rate
Repo market	Redistributes financial system liquidity Secured funding facility	Yield advantage enhances returns on securities investments Flexibility to adjust terms as dictated by cash flows projections	Reduced by enabling more efficient liquidity management under standardised documentation arrangements	Promotes financial stability Facilitates bond market liquidity and assists price discovery Trade settlement backstop
CAPITAL MARKETS				
Equities	Share prices are a key financial indicator Vital to funding the economy	Equities are a key savings outlet	Organised market reduces intermediation costs	Supports risk management products
Securities lending	Sharpens pricing by facilitating short sales	Enhances returns on securities investments	Reduced – liquidity generates reduced spreads in cash market	Market stability (less trade fails) Facilitates market making
Private sector bonds	Funding mechanism for financial intermediaries and corporates	Outlet for medium/long term investment	Provides competition for bank credit intermediation	Supports risk management products
Government bonds (CGS and semis)	Economic benchmark rate Finances government expenditure (incl. infrastructure)	Investment outlet	Organised market reduces intermediation costs	Collateral for transactions Safe haven/high quality liquid asset Supports derivatives products
DERIVATIVES				
Interest rate swaps	Key financial system pricing indicator	Enables interest rate risk management, enhancing investment returns	Reduced for financial institutions, companies and govt through efficient risk management.	Economic benchmark rate Enables lengthening of bond yield curve.
Interest rate futures	Key financial system pricing indicator	As per swaps – but with benefit of greater market liquidity	As per swaps – but with benefit of greater market liquidity	Provides for centralising of credit risk to clearing house.
Cross currency swap	Critical linkage component between capital markets in Australia and global capital markets	Broadens the range of potential issuers in the Australian debt market and the investor base	Enhances competition Reduces cost of funding for corporates, banks and their clients.	Improves financial system efficiency
FOREIGN EXCHANGE MARKET (spot & derivatives)	Key economic performance and pricing indicator	Enables capital flows and diversification opportunities Enables risk management	Reduced – enables cross border financing and competition	Economic benchmark rate Conduit for trade and capital flows

Most OTC markets are self-governed with market-imposed conventions, and over time participants have developed commonly accepted procedures for transacting, documenting and settling OTC transactions, which has resulted in an efficient and secure trading environment. In Australia these procedures have largely been formalised by the industry through the framework provided by AFMA and its market committees.

Exchange markets offer a centralised trading platform, usually with a clearing house as a principal. Market participants must adhere to the business rules of the exchange. The products traded on exchanges are standardised, which enable high volumes to be traded.

In Australia the main licensed financial market for exchange-traded financial products is the ASX Group (ASX), which operates Australia's major financial markets for equities and exchange-traded derivatives. It provides listing, trading, risk management, clearing, settlement, depository and market data services for domestic and international customers. There are a number of other exchange markets including Financial and Energy Exchange (commodity, energy, environmental and financial derivatives) and centralised electronic markets including Yieldbroker (wholesale bonds and derivatives).

2.2.2. The Major Markets in Australia

The markets each in their own way improve the operation of the real economy, to the benefit of its constituent businesses and household participants. Rather than address each of these in detail, Table 2.2 above provides an overview of key financial markets in the Australian financial system and a high level illustrative summary of their contribution to the economy.

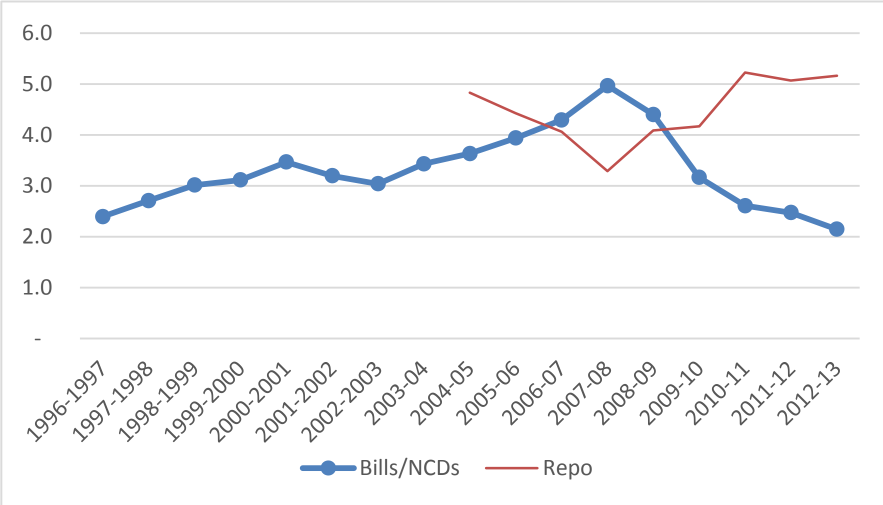
The following sections provide insights into the development of the financial markets since the time of the Wallis Financial System Inquiry and their performance during and after the GFC. As an introductory comment, we note that there is diversity in experience and outcomes across the various markets over this period. However, their critical importance to the efficient operation of the real economy is consistent and has deepened.

2.2.3. The Short Term Money Markets

Repurchase Agreements – the Repo market

A repo is a bilateral agreement under which one party sells a security to the other, with a commitment to buy it back at a later date at an agreed price. The repo market play a central role in modern financial systems by providing an efficient source of secured market funding, fostering price discovery, allocating liquidity and being the main instrument used by the Reserve Bank to undertake its domestic monetary policy operations, amongst other things.

FIGURE 2.1 – Short Term Money Markets Turnover (times GDP)



Source: AFMA

The repo market in Australia is liquid and operates efficiently. Turnover on the market is high in nominal terms (see figure 2.1), as over 70% of repo transactions are either rolled daily or have a duration of less than 1 week.

As is the case in other jurisdictions, Australia uses the Global Master Repurchase Agreement (GMRA) as its standard documentation for repo transactions. Australian market behaviors are codified under AFMA conventions specifically designed for the market, similar to the approach taken in the other OTC markets.

The vast majority of repos transacted in Australia are secured and underpinned by liquid assets of the highest credit quality; ie government bonds. The collateral support attributes of the repo market facilitate the efficient implementation of monetary policy under normal market conditions, and in stressed market conditions allow the RBA to act swiftly to promote stability. Repos support liquidity in the debt securities market and contribute to a well-functioning financial system.

The Market for Bank Bills and NCDs

The market for short term bank paper compliments the secured repo market as both a source of funding for banks and an outlet for investment. Bank bills have declined in importance and have been replaced to a large degree by bank NCDs. Other short term paper, treasury notes and promissory notes, are also traded in this market.

'Prime Bank' eligible securities are a particular asset class in the market and form the basis of the BBSW benchmark rate which is used in many bank loan and derivative transactions. These securities serve to substantially aid in managing a bank's short term funding and liquidity positions, and are comprised of senior unsubordinated bank bills and NCDs accepted or issued by the Prime Banks, which currently comprise the four major Australian banks, and where the remaining maturity of the securities is six months or less. Prime Bank securities trade as a homogeneous asset class which promotes market liquidity and assists price discovery.

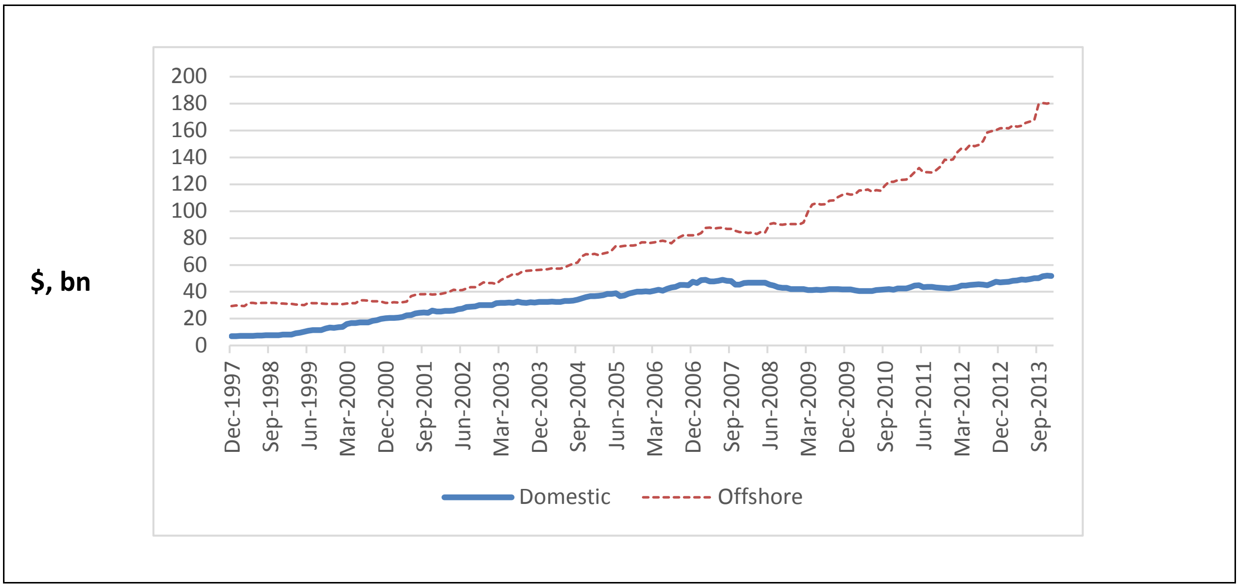
Turnover on the market declined from its peak in the mid-2000s, in part because banks have reduced reliance on short-term funding in preparation for compliance with the Basel III liquidity requirements – see Figure 2.1. Market activity is quite healthy, with average daily turnover of Prime Bank paper this year at $660 million in the 10 minutes around the BBSW rate set time.

2.2.4. Debt Capital Markets

Governments and corporates issue securities into the long term debt market, usually to fund major borrowing requirements needed for investments.[6] Investors buy the type of security that offers the payment stream, yield, maturity and risk profile that best suits their strategy.

The main issuers of non-government bonds are banks and other financial institutions which accounted for 35 per cent of non-government bonds on issue as at the end of 2013. Other significant issuers of non-government bonds are asset backed bond issuers, including banks and mortgage originators, accounting for 20 per cent of the market and non-resident or 'Kangaroo' issuers contributing to another 34 per cent of issues. The non-government bond market as a whole complements the government bond market in providing a range of fixed interest investment opportunities for investors in competition with bank term deposits.

FIGURE 2.2 – Stock of Bonds Issued by Non-financial Corporations – Domestic and Offshore

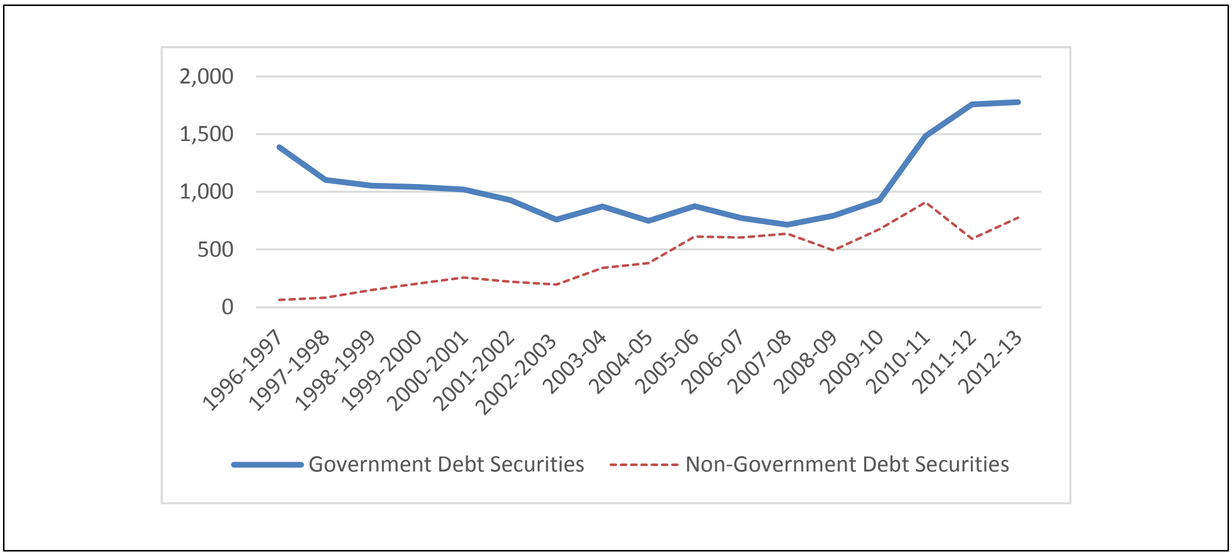


Note: Derived from RBA published statistics.

[6] Government debt is issued as Commonwealth Government Securities or state government securities (semis), by state borrowing authorities on behalf of the state governments, eg New South Wales Treasury Corporation for the New South Wales Government.

Corporate bonds have continued to be a significant source of finance for Australian companies since the GFC but, as with historical experience, most of the issuance is directed to the overseas markets where $181 billion was on issue by Australian companies at end-2013 (see Figure 2.2). The US private placements market is particularly attractive to Australian companies and an important source of finance to them because it has good liquidity, long dated debt finance is available and deals may be brought to market quickly.

FIGURE 2.3 – Debt Securities Market Turnover ($ bn)



Note: Derived from *Australian Financial Markets Report*, AFMA. Non-government debt securities include corporate, bank, asset backed, AUD foreign and foreign non-government securities.

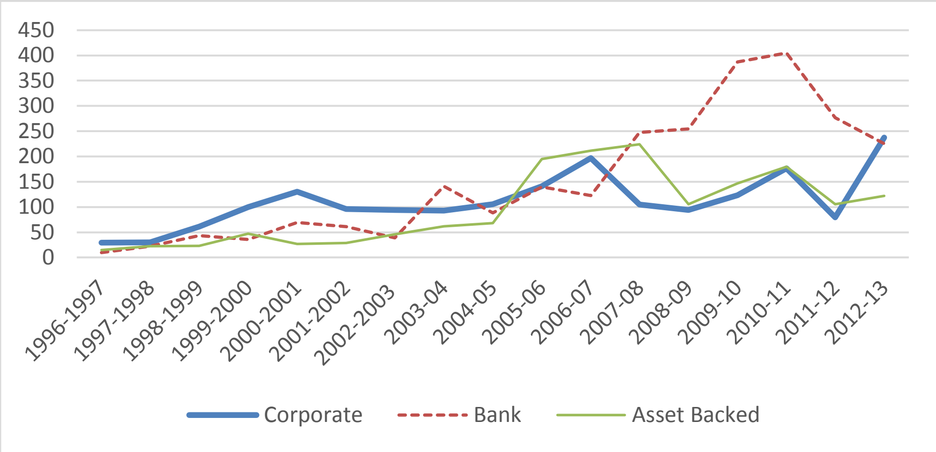
The secondary market, where securities are traded once issued in the primary market, for debt securities in Australia is primarily OTC, although most debt traders' risk management (ie hedging) is done via the exchange-traded futures market.

Government debt securities account for the majority of turnover on the secondary market for debt securities and the size of the market has varied broadly in line with the size of government debt on issue, since the time of the Wallis Financial System Inquiry; thus, picking up in recent years. The Government bond market is supported by the Australian Office of Financial Management (AOFM) through its design of issuance programs and related facilities to promote the efficiency of the market (eg by having deep stock lines) and an active repurchase agreement market, that enable traders to obtain stock to cover positions. State treasury corporations similarly manage their issuance of state government debt securities in a manner that assists the effective operation of the market.

Well-functioning financial systems will invariably serve as an attractive destination for investor's funds, and given investors demand for high quality safe liquid investments, Australia's Commonwealth and State government bonds are generally viewed favourably in this light by the global investment community. The attractiveness of this debt is enhanced by the ability of primary dealers and market makers being willing and able to price the debt, and through this process ensure that a deep and liquid market exists for these investors.

Turnover on the market for non-government bonds has grown more steadily over the years, though it was also affected by the GFC in 2008-09 and the European sovereign crisis in 2011 – see Figure 2.4.

FIGURE 2.4 – Components of Non-Government Debt Securities Market (Turnover $bn)



Note: Derived from *Australian Financial Markets Report*, AFMA.

Most of the securities are brought to the market by lead managers (ie banks) on behalf of the corporation. They are more tailored to the borrower's needs, such as term to maturity, unlike government securities. Data on the management and underwriting of private sector debt issues show there is a broad range of domestic and international banks and securities firms that service the domestic and international bond market. For example, the four leading issue managers accounted for 54 per cent of Australian dollar debt issues in 2013.[7]

As outlined in Section 1, government securities play an important role in the financial system by providing a benchmark for interest rates.

While new capital and liquidity standards have improved bank safety, the consequent constraint on bank trading inventories has reduced liquidity in some global debt markets; to some degree shifting risk to the issuers and investors who use the markets. This illustrates the importance of regulatory policy analysis that takes account of interconnectivity within the financial system when assessing the potential risk containment benefits of regulatory measures and when designing of those measures.

2.2.5. Equity Capital Market

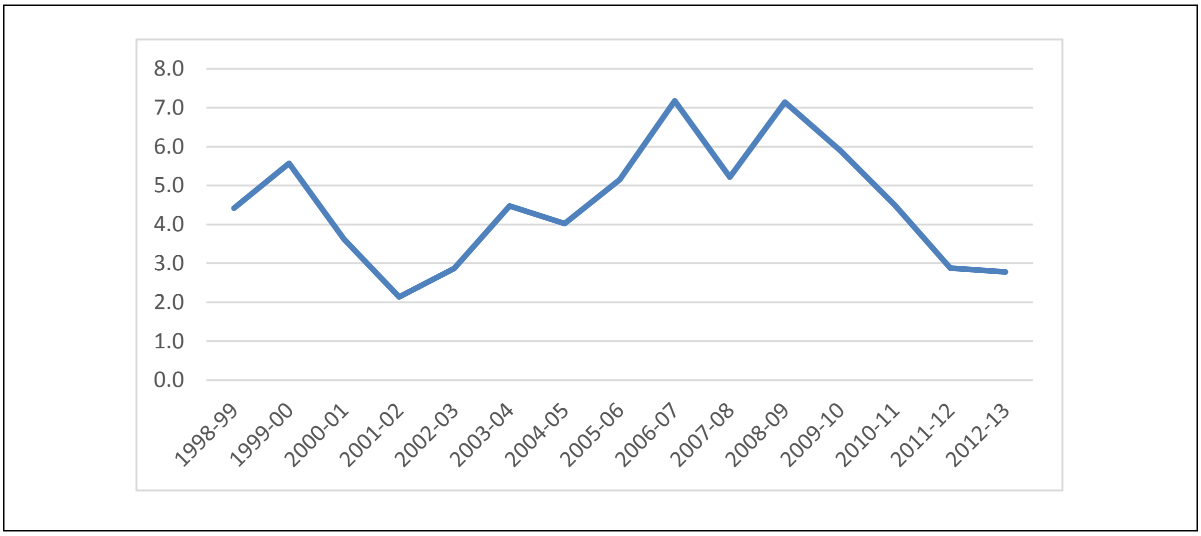
The equity market is perhaps the most visible market in Australia. It has significant retail and wholesale participation, with a relatively high level of individual ownership by international standards. ASX is the principal listing market for shares in Australia and is the main avenue through which companies seek equity finance. Secondary market trading is screen based and the main

[7] Based on Thomson Reuters data.

trading venue is ASX, though competition arrived when Chi-X commenced operations on 31 October 2011. Chi-X's market share of turnover was 15% in the final quarter of 2013.

Share issues are undertaken through an initial public offer (IPO) on the ASX and may later be supplemented by secondary capital raisings, like rights issues and placements. This is typically done with the assistance of several financial intermediaries (eg stockbrokers and corporate advisory services within investment banks). The capital raising market in Australia is highly competitive and is serviced by a wide spread of stockbrokers and investment banks. The top four firms accounted for 62 per cent of the market in 2013 and firms with an overseas affiliation form the major part of the market.

FIGURE 2.5 – ASX Listed Company Capital Raisings (% GDP)



Note: Derived from ASX data.

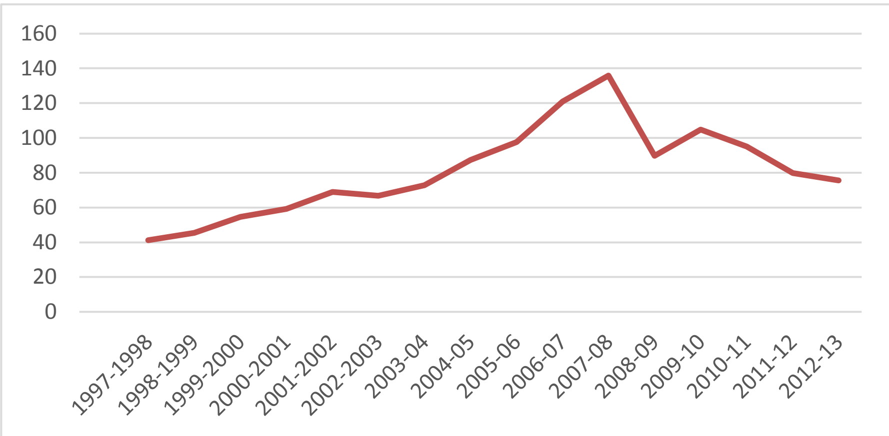
The ability of listed companies to raise equity capital quickly through the flexibility of Australia's capital raising arrangements was important during the GFC, with a record amount of capital raised in 2009 when debt markets were constrained. Thus, corporate law reform in 2007 to improve the efficiency of secondary market raisings enabled the real economy to better adapt to volatile economic circumstances. Innovation in relation to capital raising is ongoing both in terms of product development (like accelerated rights issues) and capital raising mechanisms (eg the introduction of *ASX Bookbuild* in 2013).

The market for equities trade execution services is also highly competitive, with a broad range of market participants offering services to the retail and wholesale markets. The top 4 brokers accounted for 39 per cent of market turnover in 2013. Turnover on the ASX equities market was adversely impacted by the GFC, falling by 30 per cent in nominal terms 2008-09, and it has not recovered (even in nominal terms). The reduction in market turnover also reflected a significant decline in liquidity relative market capitalisation and has presented difficult business conditions for brokers, who must also contend with compressed commissions and higher regulatory costs (including cost recovery charges for regulation).

Short selling of securities is one of the mechanisms that refines the price signals, or cost of capital, emitted by the market and is required for efficient capital allocation. Short selling helps the market to more quickly correct the price of overvalued securities and can level out fluctuations in market prices. Indeed, the presence of active traders promotes the search for information on the issuers of securities and, hence, the more rapid adjustment of prices to the economic value of a business.

Securities lending is one means to facilitate short selling but like short selling it also serves a range of other functions including arbitrage and hedging. Significant law reform following the GFC has curtailed the risks from short selling and securities lending in the Australian market.

FIGURE 2.6 – Equities Market Turnover (Annual, % GDP)



Note: Derived from *Australian Financial Markets Report*, AFMA.

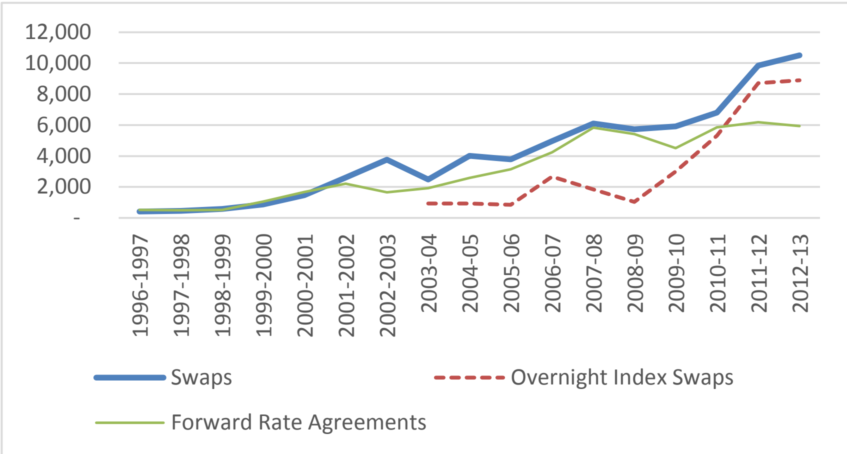
The proportion equities trading on exchange (or the 'lit' market) increased markedly due to innovation and electronic trading since the late 1990s. In addition, algorithmic and high frequency trading emerged to become a significant feature of the market. These aspects are considered in Section 3.4 of this submission, dealing with innovation in financial markets.

Stockbrokers have incurred significant additional regulatory costs in recent years due to a wide range of regulatory reforms such as short selling prohibitions and reporting, securities lending reporting, new Market Integrity Rules and Future of Financial Advice (FOFA) reforms that have been implemented in response to the GFC and related events. This has increased the operating cost base for the industry.

2.2.6. Derivatives and Other Financial Markets

Australia is well serviced by a range of efficient cash and derivatives markets (both exchange and OTC markets, which are interconnected). Since OTC derivatives markets offer sophisticated products, market providers are generally large banks, with a variety of counterparty types, the most active groups being other financial institutions, governments, and large corporates. The significant growth in the OTC and exchange derivatives markets in Australia (and overseas) reflects its value to both hedgers and speculators.

FIGURE 2.7 – OTC Interest Rate Derivatives Turnover (Annual, $bn)



Note: Derived from *Australian Financial Markets Report*, AFMA.

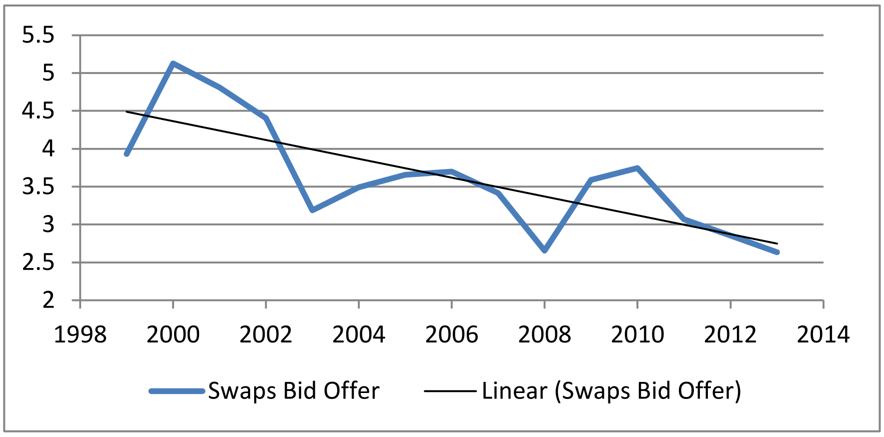
OTC Derivatives

Key OTC derivatives include interest rate swaps and shorter term forward rate agreements (FRAs). Generally an interest rate swap involves swapping a stream of fixed rate payments for a stream of floating rate payments.[8] Interest rate swaps can be used to lower funding costs, hedge interest rate exposures and implement asset/liability management strategies without altering the underlying portfolio, which is important to companies and investment managers. Swaps may also be used to take speculative positions in relation to future interest rate movements.

A narrow bid-offer spread in a financial market generally implies that the market is working efficiently and is reducing the cost to users of the instruments traded. While the AUD interest rate swap spread widened during periods of market volatility, it is evident from Figure 2.8 (below) that there has been a significant downward trend in the spread over the last 15 years or so. This reflects the growth and deepening of the market over this period.

[8] An interest rate swap is a derivative product which allows two counterparties to exchange their interest rate obligations based on a notional amount over an agreed period of time. Overnight indexed swap (OIS) is a bilaterally traded derivative in which one party agrees to pay the other party a fixed interest rate in exchange for receiving the average cash rate recorded over the term of the swap.

FIGURE 2.8– AUD Swaps Bid-Offer Spread (basis points; average all tenors)



Note: Derived from Bloomberg data.

The important role of cross currency interest rate swaps in linking Australian and overseas debt markets is also notable, as it facilitates both Australians who wish to borrow on overseas capital markets and foreign debt issuers who want to tap the Australian debt markets.[9] Figure 2.2 above illustrates the practical importance of this market to the funding of the real economy.

Consequent to a G20 agreement in 2009, OTC derivatives markets regulation in Australia and globally is undergoing major reform with emphasis on moving to new infrastructure for trading, clearing and reporting coupled with changes to the regulatory capital cost for derivatives. These reforms are significantly increasing the costs of managing risk through derivatives for market participants, including end-users, and are changing market structures.

The Council of Financial Regulators has observed that although the Australian OTC derivatives market remains relatively small, the market plays an important role in the overall functioning of the Australian financial system. The OTC derivatives market contributes to price discovery, and facilitates bespoke hedging solutions and the establishment of tailored risk positions. Australia's OTC derivatives markets performed well during the GFC and remained robust to the bankruptcy of Lehman Brothers in September 2008. Nonetheless, the Council identified a range of steps to ensure the operational and risk-management practices in the Australian OTC derivatives market meet international best practice. These matters have since been the focus of regulatory and industry initiatives, as described in this submission.

Exchange Derivatives

The largest derivatives market is that for ASX 24's bank bills futures contract, which had an annual turnover of almost $26 trillion (notional) in 2012-13. There are smaller markets for 3-year and 10-

[9] Cross currency swaps involve the exchange between two parties of the principal and interest payment (fixed or floating) denominated in one currency for an equivalent principal amount and interest payment (fixed or floating) denominated in another currency.

year Treasury bond futures, which are benchmark derivatives for the trading and hedging of medium to long-term interest rate risks. Interest rate futures offer transparency, high liquidity, immediate execution and confirmation as well as low counterparty risk. Boxes 1.2 and 1.4 above illustrate the importance of the exchange derivatives and particularly the government bond futures market to the economy; in this case as an efficient means to manage risk, which supports lower interest rates.

ASX also offers a range of other derivatives products for which there are significant markets, including for equities and electricity. These complement the underlying markets in a similar manner to the way in which interest rate futures does so for debt instruments.

Electricity Derivatives

Australia has an active OTC and futures derivatives market for electricity, which is based on prices in the National Electricity Market (NEM). The NEM is a wholesale electricity market where electricity generators and retailers trade electricity within Queensland, New South Wales, the Australian Capital Territory, Victoria, South Australia and Tasmania. Generators sell into the pool and the retailers buy from it to on-sell electricity to business and household end users. The market is operated by the Australian Energy Market Operator (AEMO), which is responsible for the management and security of its power systems.

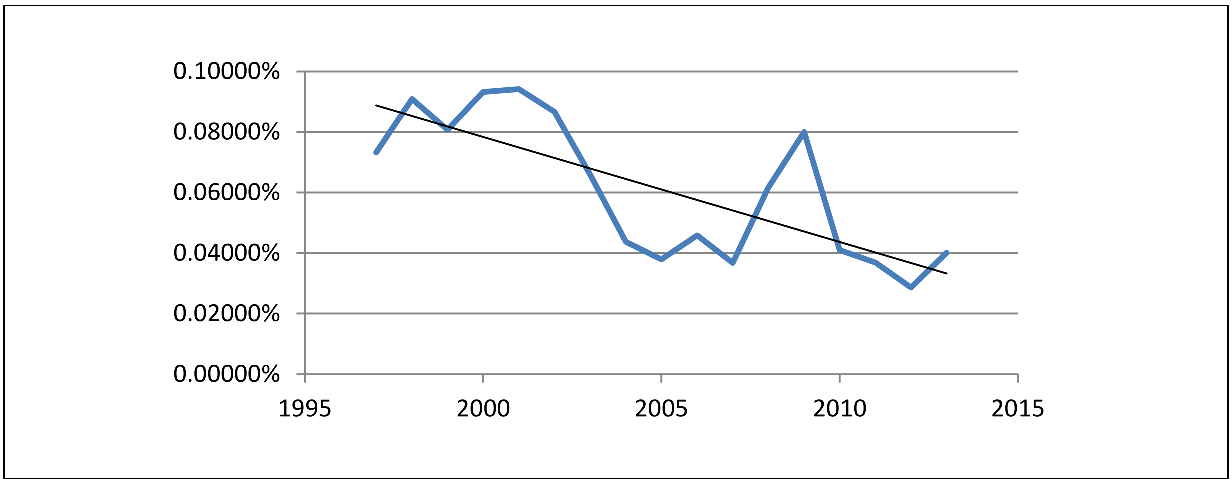
The spot electricity market is a virtual pool where bids from generators to supply electricity are aggregated and scheduled by AEMO to dispatch electricity at the lowest cost to meet the demand. The spot market is a competitive market in which prices adjust in real time to supply and demand conditions.

NEM participants face considerable market risk from the volatile physical spot prices. As generators and retailers are natural counterparties, they can readily negotiate complementary risk management strategies. By entering an electricity derivative (exchange or OTC), a retailer may be able to hedge against the risk that the pool price will rise. Similarly, a derivative may enable a generator to hedge against the risk that the pool price will fall. Electricity derivative products do not involve any physical delivery of electricity power but are settled by financial payments between the parties.

Foreign Exchange

The foreign exchange (FX) market is an OTC market that facilitates the exchange of one currency for another and, thus, is a key facilitator of international economic linkages. On average, the daily foreign exchange turnover for AUD recorded in April 2013 was USD $462 billion according to the Bank for International Settlements' Triennial Foreign Exchange and Derivatives Turnover Survey, making it the fifth most actively traded currency.

FIGURE 2.9 – AUD/USD FX Spread



Note: Derived from Bloomberg data.

The cost of transaction in the market, as measured by the bid-offer spread, declined notably during the early to mid-2000s when there was greater uptake of FX electronic trading venues. While short term market volatility affected the spread for this period, this trend has extended to recent years.

2.3. Wholesale Banking

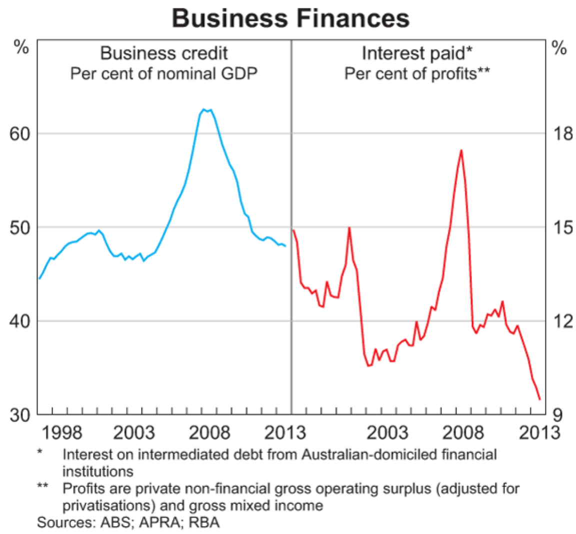
The wholesale banking segment of the financial system in Australia is large, with financial intermediary loans outstanding to business of more than $570 billion at the end of 2013. It has been, and remains, a very competitive market with some unique features that contribute to this. The changes experienced in the wholesale banking segment and its likely future development are best understood in the context of the financial system as a whole.

Wholesale banks offer a broad range of services including corporate lending, custody, agricultural finance, infrastructure financing, and treasury products and are the major underwriters of Australian debt and equity issues, amongst other things. As described above, wholesale banks are active participants in the debt capital and derivatives markets. In this section, we focus more on their role in credit intermediation.

2.3.1 Industry Trends Pre and Post GFC

Business lending was marked by strong expansion in the lead up to 2008 and then a sharp contraction in growth consequent to the GFC. The Reserve Bank publishes a chart that summarises business credit in terms of GDP, which is presented in Figure 2.10.

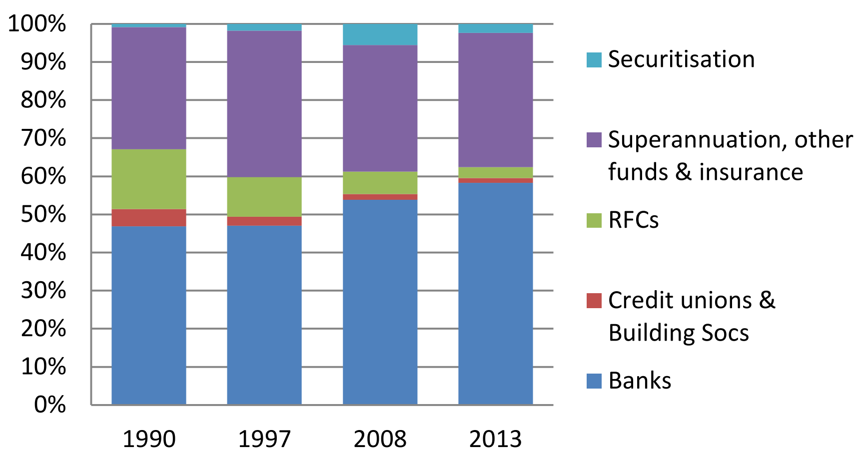
FIGURE 2.10 – Business Credit from Australian Domiciled



There are interesting aspects behind this story reflecting the changing shape of the financial system both before and after the GFC that are relevant to the Inquiry. Banks are part of the broader financial system and they face competition from non-bank financial institutions and the capital markets in important areas.

The share of financial intermediation accounted for by banks has been growing since before the time of the Wallis Financial System Inquiry and has accelerated since the GFC – see Figure 2.11. The share of the shadow banking sector (that is, credit intermediation facilitated by non-bank financial institutions) in Australia is small and declining, so it does not present the systemic risk problem associated with the sector in the USA. To the contrary, the return of a deeper and more vibrant securitisation market in keeping with its pre-GFC potential is a widely shared objective.

FIGURE 2.11 – Sectoral Share of Financial Assets over Time



Note: Chart data are derived from published RBA statistics.

The Australian banks are the key providers of finance to Australian business, accounting for over two thirds of business lending, as well as being significant participants in the Australian debt and derivatives markets. They have remained critical to funding of the economy since the Wallis Financial System Inquiry and since the GFC. As noted in Section 3 of this submission, prudential regulation of banks has been tightened which places upward pressure on the cost of financial intermediation. There is concern that the pace and form of prudential regulatory change in Australia relative to overseas jurisdictions may competitively disadvantage Australian banks (see Box 5.1 below). More generally, banks operating in Australia also have interest withholding tax applied to deposit funding from offshore, which constrains their ability to tap into overseas savings pools, while banks in key competitor centres do not face this constraint.

Foreign banks are the other significant providers of business finance, with registered financial corporations (RFCs) still significant but exhibiting a steady decline in market share both before and after the GFC. The foreign banks play a dominant role in parts of the investment banking industry, which enhances competition for banks from capital markets.

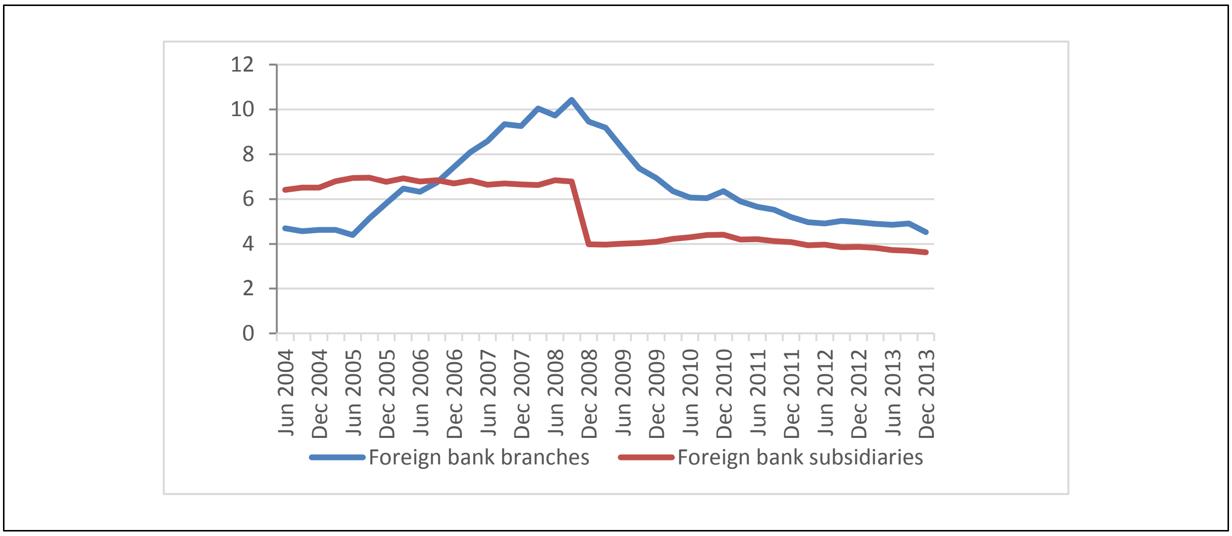
Policy reforms introduced in 1992 enabled the establishment of foreign bank branches. Over the following decade the largest merchant banks (which are not prudentially regulated by APRA) and many licensed bank subsidiaries converted to foreign bank branch status in response to a range of business and regulatory factors. Reforms following the Wallis Financial System Inquiry also played a role by improving the competitiveness of licensed banking relative to non-bank financial intermediaries; for example, through abolition of the Reserve Bank non-callable deposits.[10]

Figure 2.12 illustrates the strong growth in the businesses of foreign bank branches over the period leading up to the GFC. This had significant benefits for borrowers through lower loan costs. The Reserve Bank of Australia, in the March 2007 Financial Stability Review, observed in relation to business lending that "*The activity of foreign-owned banks appears to have been one of the catalysts for stronger competition in this market, which in turn has been associated with a contraction in lending margins.*"

However, foreign bank branches lost significant market share as a consequence of the GFC; falling by almost half since 2008. This is largely due to contraction by European banks whose market share (total resident bank assets) fell from 9 per cent at the end of 2007 to 2.8 per cent at the end of 2013. In contrast, the market share of Asian banks exhibited solid growth over this period but coming from a much lower base it can only ameliorate the downward trend for foreign bank branches as a whole. The market share of foreign bank subsidiaries (domestic regional banks) also fell consequential to the GFC, due to acquisition of entities by the major Australian-owned banks.[11]

[10] Banks were required under the Banking Act 1959 to hold 1 per cent of their liabilities with the Reserve Bank as non-callable deposits and the interest paid to the banks on these funds was 5 per cent below the prevailing market rate.
[11] Foreign bank subsidiaries' market share fell, largely due to the sale of Bank West to CBA.

FIGURE 2.12 – Foreign Banks' Share of All Bank Loans



Note: Foreign bank branch market share for commercial lending shows a similar trend but peaks at 24 per cent (as foreign banks lend mainly in this market and do not provide home loans). Source: APRA data.

Foreign banks, including some without a local operating presence as an Authorised Deposit-taking Institution (ADI), participate in the Australian corporate debt market through syndicated lending arrangements. This adds a further competitive dimension to the large business loan market. Australian banks were mandated arrangers for 54 per cent of Australian syndicated loans totalling $101 billion in 2013, with a good spread of foreign banks making up the remainder of the market.[12]

2.3.2 Competition from Capital Markets

The corporate loan business of financial institutions is subject to more competition from the capital markets. While the degree of substitutability of different funding sources varies, there is nonetheless a competitive relationship between them.[13] For example, when capital markets were under severe stress in late 2007, there was a period of re-intermediation as companies turned to banks instead of raising debt directly from capital markets. In other periods, weakness in business credit has been somewhat offset by increased funding using bonds and notes.

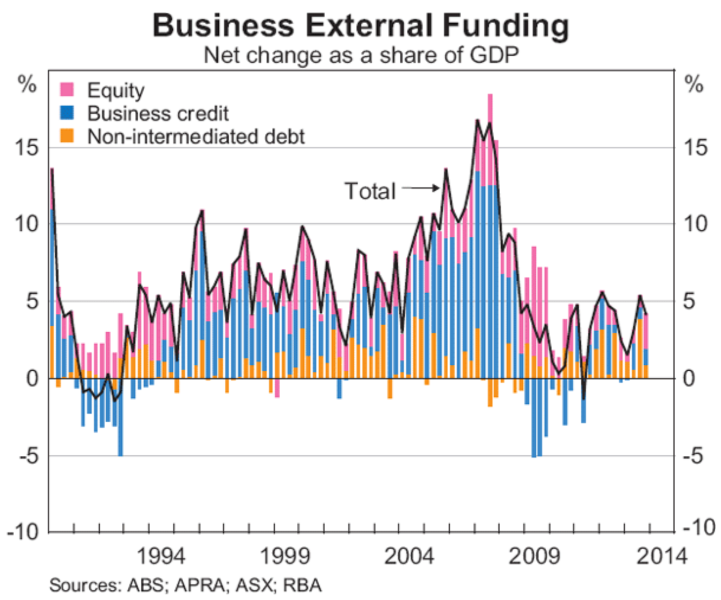
Figure 2.13 is a Reserve Bank chart that summarises the external funding available to Australian business and their reliance on the various funding sources over the years.

There was a discernable shift towards bank funding in the years leading up to the GFC. However, the ability of listed companies to raise equity capital quickly during the GFC when debt markets were constrained was an important mechanism enabling many companies to reduce debt exposure and strengthen their balance sheets. Subsequently, there was a noticeable shift in the composition of

[12] Thomson Reuters data.
[13] While the intrinsic properties of debt and equity are different, they are nonetheless imperfect substitutes that may have more or less relevance at different points in time. Corporate bonds and promissory notes do have similar characteristics to bank intermediated debt but they are not a perfect substitute for borrowers or investors; for instance, bank loan arrangements are more flexible than bonds but the latter are more readily tradeable.

external funding, with capital market sources (equity and debt) becoming more important in contrast to the growing market share of bank credit in the lead up to the GFC. This highlights the benefit of diversity in the financial system in financing the real economy.

FIGURE 2.13 – Business Funding



In relation to capital markets services, foreign banks are sometimes attractive to corporates as the primary transactional bank given their significant presence in and, therefore, access to the international capital markets. The competitive presence of foreign banks in this context is illustrated by the fact that foreign banks were the book runner for well over 80 per cent of Australian international bond issues of USD85 billion in 2013.[14] The Australian banks play the leading role in the issuance of domestic corporate bonds.

[14] Thomson Reuters data. The book runner is responsible for tasks such as inviting institutional investors to subscribe and allocating bonds to subscribers.

SECTION 3 – Trends Driving the Future of the Financial System

KEY POINTS

- Demographic change, the "Asian century" and the infrastructure investment gap will shape the future demand for financial services, while technology, regulation and innovation will determine the capacity of the financial system to respond.
- The changing shape of the financial system, including the growth of superannuation and new regulatory standards that apply to banks, point to a structural shift in the financial system towards market-based financing.
- The future success of the financial system in adapting to this change will depend to a great extent on how well its participants use technology and other resources to adapt to the changing conditions.
- Financial innovation will be required across a range of areas to enable the market to meet the investment needs of superannuation funds, the funding needs of business and the long term capital requirements of infrastructure projects.
- Government, regulators and the industry all have a responsibility to promote innovation, competition and international competitiveness that will drive the dynamic efficiency of the financial system.

3.1. Introduction

If the role of the financial system is to serve the economy, its purpose being to enable the efficient conduct of commerce and personal business, then the Inquiry needs to consider likely changes to the way our economy works and then also make judgments on how this needs to be reflected in the future operation of the financial system. Against this backdrop, this section:

- Stands back from the financial system to examine the major drivers of economic change and development;
- Identifies key drivers of change in the mechanics of the operation of the financial system itself; and
- Given these circumstances, draw conclusions about how the financial system may then rise to meet the challenges of optimally serving the economy.

The final part of this section focuses on innovation as a key ingredient in the optimal response to the opportunities and challenges presented by economic and financial system change. The right policy and regulatory settings will promote innovation in financial products and services that address major challenges, like funding the economy, in a way that enhances productivity through effective capital allocation and reduces the cost of operating the financial system.

3.2. Economic and Societal Trends

Changes to the way our economy works and the values that underpin our society evolve over time and can have profound impacts for individuals, governments and businesses. It is not our intention to explore and articulate each of the major changes; rather, we accept the conclusions of research undertaken by CSIRO and others identifying megatrends, including:

- The need to extract more from less, as the earth's resources are depleted and populations grow;
- Threats to the world's natural habitats, plant and animal species;
- The shift in the world's economy from west to east and north to south;
- The challenges and benefits from an ageing population;
- Increased connectivity through digital media that are creating a virtual world; and
- Rising demand for experiences over products and the rising importance of social relationships.

These are trends that will help shape the future of the financial services industry through their effect on both demand and supply. For instance, individuals may seek increased ready access to financial services that are more personalised, while evolving technology enabling management of large volumes of data can allow efficient delivery of more tailored financial services.

Change components that are of most relevance to the Inquiry and need to be considered in the context of its conclusions are:

- *Demographic Change*
  Birth rates have fallen and lifespans have lengthened over recent decades, driving up the median age in Australia, along with many other countries. This ageing of the population has significant social and economic implications, as there will be fewer workers to support retirees and young dependants which will place pressure on the economic growth that drives rising living standards. It will also have a significant impact on the composition of demand for financial services.

  Most notably, demographic change will be a major determinant of growth in superannuation savings, the drawdown of superannuation savings over time, the average risk profile of investors, the likelihood of an increased retirement age and the allocation of superannuation assets. Financial products and markets, like the fixed interest market, will evolve to satisfy this demand, as will supporting resources like investor advice, financial literacy and delivery processes.

  There is a strong impetus to maintain policy settings that promote increased private retirement savings through superannuation and increase the level of self-funded retirement within the community.

  The need for a fully effective financial system will be increasingly important in this respect as we look to the future. The eventual drawdown of savings as the number of retirees increases (both in Australia and developed overseas economies) will make capital scarcer and, against this backdrop, the challenge of maintaining economic growth and living standards will place even greater reliance on the available capital being put to the most productive use. In other words, it is imperative that the savings generation and capital allocation function of the financial system is first-class over coming decades.

- *The "Asian Century"*
  Estimates suggest that, by 2020, Asia's economic output will be larger than Europe's and North America's combined.[15] The growing development and integration of economies and financial markets in the Asian region presents good opportunities for Australia, including our financial services industry. We can build on our trade and investment ties with China, India and other countries to extend the development of our financial services industry and deepen the linkages between our capital markets and those in the region. This provides the potential for more effective access to the region's capital for Australian business, diversification options for Australian investors and greater export revenue from financial services.

  The integration of the Asian and Australian markets is still in its infancy in some respects and the potential for growing these links to assist the national economy presents a commercial challenge for business and a policy challenge for the Government.

  The employment and income growth that should accrue to Australia from financial services in the Asian Century will only eventuate if the necessary policy settings are put in place. Australia has a demonstrated capacity to develop the kind of innovative policy required to promote financial services exports to Asia. However, we have not made this outcome a priority in the past and, by falling short in our execution of policy intent, we have lost business to overseas locations. Asia could benefit from the expertise of Australia's mature superannuation industry and technology as a centre of excellence and politically stable environment for wealth management.

- *Infrastructure Investment Gap*
  Australia has a backlog of infrastructure investment and a significant infrastructure deficit, estimated at around $300 billion.[16] The backlog is a constraint on long term productivity and growth, which is widely acknowledged.

  Governments are traditionally the key providers on infrastructure but they are unable to fund the current gap out of normal revenue sources. The required solution has many dimensions, including actions like the transfer of public assets to the private sector and public-private partnerships in new infrastructure projects. The financial system has an important role in closing the infrastructure gap by facilitating alternative funding

[15] Australian Government 2012, Australia in the Asian Century - White Paper.
[16] http://www.infrastructureaustralia.gov.au/coag/files/2013/2013_IA_COAG_Report_National_Infrastructure_Plan_LR.pdf

arrangements. For instance, it can assist with the recycling of capital by selling or long-term leasing of government infrastructure assets and re-investing the proceeds in new infrastructure, which is not happening to the extent required today.

While this involves the financial sector stepping into a traditional financing role, the long term funding requirements of infrastructure projects pose particular challenges that will require innovative solutions. For instance, it will be necessary to implement market solutions that better align long duration investment requirements of superannuation holders with the long term funding requirements of infrastructure project developers.

3.3. Endogenous Financial System Developments

The way in which the financial system develops going forward will reflect both the broad economic and societal trends but will also depend equally on the factors that influence the capacity of the financial system to respond to these needs.

Development of the financial system will also be impacted by these factors including:

- *IT and Technological Developments*
  Technology has had a huge effect on the development and operation of financial markets since the Wallis Financial System Inquiry and will continue to do so going forward. This placed downward pressure on transaction costs, with market users benefitting from much tighter bid-offer spreads – for example, see Figure 2.8 in Section 2 which illustrates the decline in foreign exchange spreads.

  Financial markets now operate in a much faster mode, accommodate large volume trading and incorporate enormous amounts of data. Technology enables the wider distribution of financial information and provides much greater capacity for both investment and risk management analysis.[17]

  The benefits are not limited to the institutional market, as retail investors get more direct and flexible access to financial markets and services at a lower cost. The way in which individuals engage with financial services providers, like banks, is radically different to the mid-1990s, largely because of technological development. For instance, retail investors increasingly rely on the internet and electronic devices to make bill payments, transfer funds, receive information on investments and financial services and undertake investment analysis.

[17] Consider two examples; one institutional and one retail. The market risk framework and controls embedded in the Bank for International Settlements ongoing Fundamental Review of the Trading Book for banks [http://www.bis.org/publ/bcbs219.pdf] is only made possible through utilisation of sophisticated and high powered computer technology. Retail investors can now avail of a range of online credit and investment analytical tools; for example, through online calculators to determine their required superannuation savings to meet their retirement income objectives (making certain specified assumptions).

The trend towards electronic trading in financial markets will continue under the natural force of market innovation but will be reinforced by the consequences of regulatory reform for the wholesale OTC markets in particular. Business and regulators have been more focused on the operational and market risks arising from greater reliance on technology. Balancing this, technology has also provided solutions through more effective market surveillance systems and risk management capability (eg OTC portfolio reconciliation and compliance systems). These aspects are likely to be an ongoing feature of the system; for example, with cash equities risk reduced through a shorter settlement period.

In summary, financial markets bring people together and technology makes this much easier. Technology increases the autonomy and capability of individuals in managing their financial affairs and enhances the capacity of investors, institutions and markets to reduce investment and other risks. It also introduces new operational and integrity risks into the financial system that need to be managed. Good regulation is key to an effective response. Technological change should be embraced by governments and regulators, with a focus on managing the associated operational and regulatory risk to ensure the best outcomes for the economy.

- *Regulation – High Financial Intermediation Costs*

  The regulation of banks and financial markets intensified markedly in response to the GFC, increasing the cost of financial intermediation. The full extent of cost increases have yet to be felt; in part because some key reforms are in a transition phase. Reform of the global financial system was necessary and higher transaction costs are unavoidable but should be offset by the benefits of a safer financial system. Of course, striking this balance is easier said than done, especially with the high volume of broad ranging reforms – there isn't any area of the financial system that has not been significantly affected. The extent to which this will be achieved in practice is uncertain. The policy and regulatory processes to achieve the right balance in regulation are considered in Sections 4 and 5 below.

  The principal reforms include:

  - The Basel III capital and liquidity reforms, which are increasing the cost of financial intermediation by banks.
  - The major reforms to OTC derivatives markets regulation consequent to the G20 Pittsburgh agreement in 2009, with emphasis on moving to new infrastructure for trading, clearing and reporting coupled with changes to the regulatory capital cost for derivatives. These reforms are significantly increasing the costs of managing risk through derivatives for market participants, including end-users, and are changing market structures and the cost of the technology changes themselves.
  - The ongoing implementation by stockbrokers and securities companies of a wide range of regulatory reforms, such as short selling prohibitions and reporting, securities lending reporting, new market integrity rules and FOFA reforms that have been implemented in response to the GFC and related events. This has increased the operating cost base for the industry.

- Government charges on industry to recover the cost of regulation, which have grown rapidly post the GFC. These charges impose a significant burden on the industry in financial terms and they distort market behaviour.

There has also been a raft of other domestic reforms such as the Unfair Contract Terms Act, the Personal Properties Securities Act and a new credit regulatory regime. For instance, margin lenders have been required to absorb a significant change management burden through major legislative changes in 2010, at a time when earnings have declined.

The amount of the cost increase from the various regulatory reforms is difficult to quantify. In part this is because banks would have independently adjusted aspects of their business and risk management arrangements to take account of the lessons from the GFC. It is also because no-one fully understands the impact of the complete range of reforms on the system, beyond the point of immediate impact. However, it is clear that the regulatory cost base of the industry has significantly increased in recent years.

These regulatory reforms are leading to structural change in the financial system, which is pushing towards greater reliance on market-based financing as a source for funding our economic growth. Therefore, it is anticipated that our economic prosperity will depend even more on financial markets in the future, as landmark regulatory and economic change takes effect. Senior regulators and industry figures are alive to this issue but there are many practical challenges to be met and we take up these issues in Section 8 below.

- *Product and Infrastructure Development*
  The combination of technology development and regulatory reform, along with lessons from the GFC, is shaping the evolution of financial products and financial market infrastructure.

  There is now a premium on less complex and more standardised products. The banking and OTC regulatory reforms increase capital requirements for derivatives that are not centrally cleared while in the future it is likely that trade reporting will be less costly for participants if reporting is done through centralised trading platforms.

  Moreover, both financial services providers and their clients are more conscious of the risks posed to them respectively by complex products that are often less transparent and more difficult to value. For instance, providers must be concerned about legal and reputation risk from their engagement with and offerings to clients, while investors learning from experience now require a greater understanding of the features and risk probabilities associated with a product.

  While the shift in regulation intensity is a global phenomenon (albeit with a specific local dimension), Australia has also been subject to a tightening of tax rules for complex financial arrangements and structured products over the last 15 years. This is a result of law reform, like measures to reduce interest deductibility of structured investments and the introduction of a tax promoter regime, and a sustained effort by the Australian Taxation

Office (ATO) in its administration of the law to minimise any risk to tax revenue that might be posed by structured products and complex arrangements.

The actual costs and level of resourcing to develop new product and platforms could, themselves, be a barrier to entry with regards to innovation and which should be considered.

In summary, financial products in general have become more standardised and simpler, which has enabled the development of more centralised and formal market infrastructure. One of the challenges for the financial system going forward will be to maintain product and service innovation, and niche market capability to service the economy, which is required to ensure the ongoing dynamic efficiency of the financial system. As discussed in Sections 4 and 5, this will require a balance between innovation and protection in the policy settings, legislation and administration of both the tax and financial regulation systems.

- *Competitiveness of Australia as a Location for Finance Industry Businesses*
  The global industry's adjustment to the GFC and the high value of the Australian dollar have adversely affected the competitiveness of Australia as a producer of financial services, both for domestic use and for export. The appreciation of the Australian dollar is a consequence of the resources boom and a stronger economy in global terms. This has increased the cost of conducting business operations from here and has accentuated the effects of the geographic consolidation of global banks' businesses and operations in response to the GFC. Thus, the trend has been to conduct less traditional back office functions in Australia and a greater amount of trading activity in some markets is done from other centres in the region.

  On the positive side, Australia has many highly valued competitive attributes including a highly skilled workforce, a sound and well regarded legal and regulatory system and it is an attractive location to live and work. In addition to domestic demand for financial services to enable economic development, there are emerging business opportunities as the high economic growth Asia continues to experience is producing large middle classes and an associated increase in demand for financial services.

  However, Australia needs to improve its performance in assessing, adopting and implementing policy initiatives if we are to capture the full benefit of domestic demand and Asia's expected growth through employment and income benefits for Australians from financial services industry exports. As discussed in Section 11, the Government should give an unequivocal policy commitment to developing our financial services sector and its exports.

3.4. Innovation, Dynamic Efficiency and Financial System Development

The future success of the financial system will depend to a great extent on how well its participants use technology and other resources to adapt to the changing economic and social trends that underpin demand for their services. This will involve uncertainties and challenges.

For example, it is expected that capital markets will play a greater role in funding economic growth, but as yet, the business models and products that might best achieve this are not known. Similarly, there is an infrastructure financing gap that banks will be unable to fill but superannuation funds could help close if we can overcome the challenge of developing the right set of capabilities and products to enable this.

Clearly, there is a lot for the financial system to do that is important to the economy but we will only be successful if innovation, as a key driver of economic development, is permitted to thrive. This means that new products and services need to be accepted and promoted by government, market participants and regulators.

Innovation is the basis of productivity in the economy both through its direct impact on the returns from investment in the economy (ie lifting the quality of investment) and also by enabling financial services that most effectively meets the needs of the economy. The financial system has a sound tradition of innovation, which is central to its ongoing dynamic efficiency and has delivered significant benefits to its users.

Dynamic efficiency involves a trade-off between short term economic considerations and the productive efficiency of the financial system over time. It is necessary to achieve the right balance within this relationship to ensure the financial system, and the economy, perform to its potential. In other words, there is cost to innovation through the economic resources it absorbs and its impact on existing capital. Therefore, it is important to ensure that innovation that is undertaken is a good use of these resources and is worthwhile in practice. This is an area where policy and regulation should be designed to promote the effective operation of the market process in allocating resources.

A financial system that is dynamically efficient requires ongoing innovation in its products and services (including delivery channels) that is pitched at the optimum level. A range of factors will affect the return from allocating resources to innovation and, thus, influence the outcome in practice. These include the capacity of the regulatory and tax systems to accommodate and support innovation, as well as factors like competition that provide a commercial incentive to allocate resources to product and services innovation.

Innovation and Competition

Competition incentivises the search for better client products and drives down the cost of financial services, which is a litmus test for the effectiveness of the financial system.

Innovation that is based on competition can provide enormous economic benefits to business, investors and householders. This was demonstrated vividly in the mid-1990s, when market and product innovation gave life to a vibrant home loan securitisation market. The wholesale markets in Australia and overseas were used to fund mortgage originators who brought down margins on housing loans by more than two percentage points (reducing annual interest payments on an average home loan by over $6,000 per annum in today’s terms).

The benefits of innovation within the financial system are significant, if often not quite as dramatic as this. Many have the effect of reducing the costs of transactions, which is a clear economic benefit to the economy. For example, the introduction of online trading has transformed the market place for retail investors, making it both more accessible and less costly.

Of course, lower transaction costs will stimulate greater trading but this is a positive outcome as it promotes a more efficient distribution of capital and risk, such that it is more in keeping with the requirements of the economy and its participants.

While innovation is central to the future development of the financial system, it can challenge or be disruptive to traditional practices of existing stakeholders. An appropriate policy framework can help guide and manage beneficial change processes that take account of these issues within the framework of the needs of the broader economy.

Industry Pressure

Established businesses have traditionally been the key source of innovation and drivers of change in the financial system. They typically also have significant capital investment in the current operating structure of the system, so some may see aspects of innovation as a competitive threat to their business. Thus, the innovation process can also cause some strain within the industry – see Box 3.1 for a recent example.

BOX 3.1 – Industry Debate on Recent Innovations in the Equities Market

Tensions within the financial services industry about high frequency trading (HFT) and dark pools in the Australian cash equities market that were evident in 2010-13 illustrate the different perspectives that can emerge within the industry about the economic value of a new innovation.

Technology advances has enabled the rapid distribution and assimilation of market information and real time deployment of trading strategies. HFT is one response; using computer algorithms to generate large numbers of trades based on price movements and other market information. Speed is critical to HFT firms, who seek to profit by market making and arbitrage transactions in the market.

The application of new technology has also made it easier and more common for stockbrokers to match client orders, or for market participants to trade directly with their clients, away from open (or "lit") exchange markets, in broker crossing systems (so called “dark pools”).

Some of the public criticisms of HFT were strident and did not acknowledge the liquidity benefits brought by low latency market makers. The merits of dark pools (a form of systematic off-exchange trading) were also subject to significant debate within the industry at this time, notwithstanding investor demand for these facilities as a means to reduce transaction costs.

Clients of financial services providers receive the benefits of innovation in the form of new products and services but they also face a range of issues in responding to change. New products and services may involve a change to established thinking, be simpler or more complex, and introduce new competitive risks and new operational requirements. Experience generally lessens these aspects because clients become familiar and comfortable with the nature of the change and focus more on maximising the opportunities it presents.

Regulatory Bias

Regulators face a challenge in supervising market conduct and enforcing regulation in an industry that is innovative and rapidly changing. For instance, they require the knowledge, technical capacity and know-how to ensure that market integrity and consumers are protected. There is a policy trade-off between ensuring 'consumer protection' and promoting innovation that involves risk. For instance, regulators may be concerned about the ability of investors, particularly retail investors, to understand new products and services, especially if they are in any way complex.

This natural concern about innovation, together with some industry feedback being given to regulators, can reinforce a natural tendency for regulators to be conservative in their actions,[18] and reinforce the *status quo*. Because innovation usually involves some element of uncertainty or risk for market participants, their clients and regulators in the early stages of its application, this can create a risk of an unduly restrictive regulatory approach to innovation. The outcome will depend on the capacity of government's policy framework and the financial regulators to recognise and address this regulatory bias.

BOX 3.2 – Government Response to Recent Innovations in the Equities Market

In the absence of a specific government policy position or a Treasury policy consultation paper on HFT and dark pools, ASIC's consultation on the regulation of these activities in effect became the battle ground for affected stakeholders to influence both policy and the regulation of HFT and dark pools.

In respect of HFT, ASIC commissioned empirical research contradicted the more extravagant criticisms and brought more balance to the public debate. This helped to re-assure investors about the net benefit to the market of well-run low latency, electronic trading businesses. At the same time, ASIC in effect sought to restrain HFT by supporting a message based model for cost recovery for market supervision. As the message charge is associated with posting prices as well as trading, it acts as a disincentive for HFT firms to make markets and so support liquidity.

In relation to dark pools, ASIC introduced price improvement requirements, requiring off market trades to be made at higher than the best available bid and lower than the best available offer for the relevant product by one or more ticks (price steps) or at the midpoint of the best available bid and best available offer. The effect of this has been to curtail the use of dark pools in circumstances where clients may otherwise obtain a benefit through lower transaction costs or a better price.

The Government has sought to provide greater policy direction by asking Treasury to undertake consultation on the licensing of financial markets, including if or how market licenses should be required by dark pools.

[18] UK Prime Minister, Tony Blair, referred to this phenomenon in a speech at the Institute of Public Policy Research in 2005; he said that because it is in the regulator's interest never to be accused of missing a problem, they tend to err on the side of caution.

Tax administrators may also seek to slow the development of new products that they find challenging to understand or that may not neatly fit within the structure of existing law. This is a natural response, as tax officers (like regulators) do not participate in the market and are not well placed to understand and make judgements about leading edge advances in financial markets. The consequential uncertainty can give rise to undue caution, especially given the very high priority the Tax Office accords to tax revenue protection. This approach, if left unconstrained, would reduce the potential effectiveness and productivity of the financial system and disadvantage the economy.

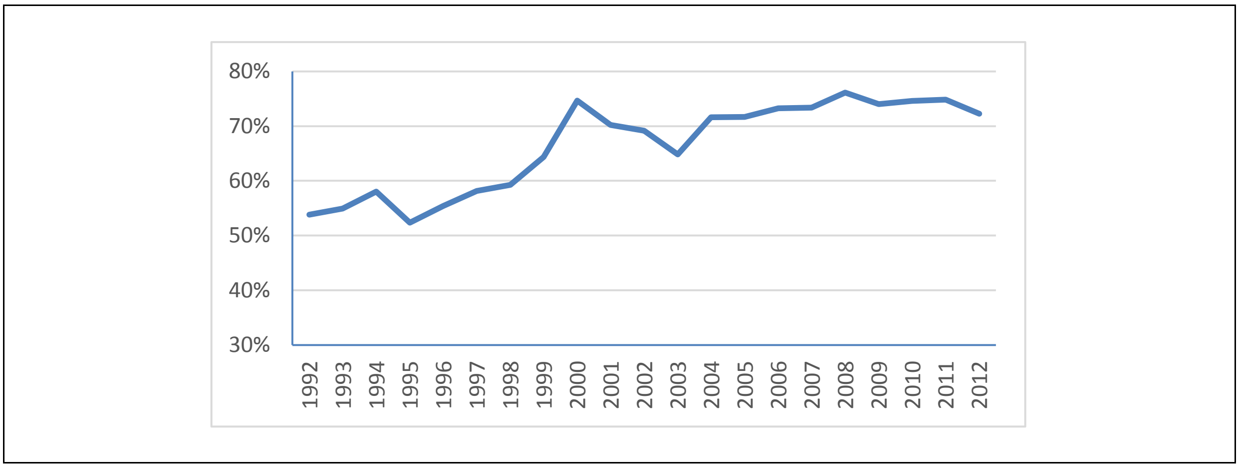
AFMA acknowledges that the ATO is currently implementing measures that will allow for a more commercial approach to tax administration to be fostered, such as Practice Statements that compel the ATO to provide assurance that it will administer and interpret new laws in accordance with the policy intent in advance of the laws' passage through parliament. This is a welcome step to ensuring that any innovation that is supported by law change will not be administered in a contrary fashion.

Government and Industry Response to Innovation

There is evidently a range of factors that could hinder innovation, which generally reflect the risk it poses to various participants in the system. Positive steps can be taken to ameliorate this problem.

The answers to the policy questions posed by innovation are rarely black and white but instead require good judgment in forming conclusions. This highlights the need for a rigorous and objective testing of any proposed policy response to innovation. Policy makers and regulators need to operate on the premise that financial innovation is of itself a good thing for the economy and take a long term view of innovation and its likely effect. This perspective should be incorporated into the cost benefit analysis of regulatory proposals. Innovation is an ongoing process that will have different impacts over time and taking too short term a view may lead to incorrect policy analysis and conclusions. Indeed, this is a point that applies to policy making more generally.

FIGURE 3.1 – ASX Equities Trading – Share of Lit Market



Source – Derived from ITG data.

For instance, concern speculating that the effect of HFT may be to push some share trading into the "dark" (ie off exchange) needs to be balanced against the fact that market innovation, including electronic trading, helped to lift the level of trading on the “lit” market (ie on-exchange trading) significantly in recent decades (see Figure 3.1). Moreover, innovation itself may generate market-based solutions for the risks it creates; for instance, algorithmic development is being applied to enable the buy-side to respond to HFT and become liquidity providers themselves.

The operating mandates given by **government** to financial regulators should require them to have regard to the dynamic development of the financial system and, in particular, to accord an appropriate priority to facilitating competition and innovation and supporting the international competitiveness in their decisions and actions. This could be judged against the potential for relevant innovations to improve market efficiency, improve price signalling and capital allocation, support savings, promote market integration and reduce transaction costs, as described in Section 1. This would help to counter the natural bias towards conservatism in regulation. Governments themselves may wish to think about actions they might take to foster innovation in the financial system. This could set the example for other institutions and organisations to do likewise.

Regulators (including tax administrators) have a better chance to understand and respond effectively to innovation if they are properly resourced through skilled personnel and support services to confidently assess the market efficiency, integrity and systemic implications of emerging new products and services. Therefore, it is important for regulators to maintain the requisite skill set within their organisation. However, they also need to promote a culture within their organisation that supports a well-balanced response to innovation, so this skill set is used in a positive way for the economy.

Industry participants also have a role in ensuring that their response to innovation will assist innovation in the financial system to reach its full potential. Industry can take positive steps to develop and promote best practice guidance and good risk management practices in relation to new products and services. Industry bodies can, with their members, rigorously and objectively assess change and then work with government, the regulators and other stakeholders to share information on market developments and promote a better understanding of their implications.

In addition, recent experience has shown that industry participants should take steps to educate stakeholders on the nature of an innovation and its implications for them. This approach would minimise the risk of the innovation being misunderstood or misrepresented and, hence, support its broader acceptance.

Confidence is critical to the effectiveness of financial markets; in this respect it’s like a public good. To help maintain confidence, industry participants should take a measured approach to commentary on market innovations and not overstate either the gains or risks from innovation.

SECTION 4 – Policy and Financial Regulation

KEY POINTS

Policy

- Parliamentarians face a daunting task in grappling with policy development for a highly complex financial system. Legislators need to maintain their policy-making authority and ensure that they have access to highly capable and objective policy advice from Treasury to understand the implications of the laws they are making.
- It is important to retain an intellectually strong and well-resourced policy-making capability in Treasury that is able to take a strategic, objective approach to financial system oversight and law reform. In its future planning, the Government needs to give attention to this, as this capacity has been reduced.
- To provide core policy co-ordination of the financial sector regulators, the Government could consider appointing Treasury as the chair of the Council of Financial Regulators.
- There should be a clear articulation of the roles of policy-makers and regulators to ensure that the lines between policy-making and implementation are well defined.

Regulation

- Delegation of detailed rule-making authority to a regulator is necessary because no strategic policy-maker can foresee all policy issues that might be encountered; in practice it is a pragmatic way to deal with complex issues.
- Clear and appropriate guidance should be given to regulators on the use of their delegated rule-making powers.
- The Government should consider the creation of an Inspector General of Financial Regulation, as proposed in the Uhrig Report, to review the work of the financial sector regulators.
- Industry involvement in the regulatory process, including through self-regulation in appropriate cases, should form part of the future regulatory fabric of the Australian financial system.

Cost Recovery for Regulation

- The significant recent growth in cost recovery from the industry and the absence of rigour and discipline in the policy and practical basis upon which this is determined is a matter of concern from a financial system efficiency perspective.
- Cost recovery for regulation presents a significant ‘moral hazard’ for government.
- The Government needs to introduce a coherent policy framework to determine if a cost recovery charge has a sound economic basis and, if so, that it sits within a coordinated policy framework that takes into account the economy-wide impact of multiple service charges.

4.1. Introduction – Financial System Policy Process

Although the Australian financial system, including its regulators, performed well throughout the GFC and since, the important lessons from overseas experience has not been lost on Australian policy-makers and regulators. Moreover, Australian regulators have traditionally been wholehearted adopters of international regulatory standards. This in combination with local events, like the collapse of Storm Financial, has led to a considerable tightening of financial regulation in Australia in recent years.

As discussed in Section 1 of this submission, the regulatory burden imposes a cost on the real economy, so it is important that the approach being adopted reflects the nature of our financial system and is proportionate to the matters of concern to us. To achieve this, it is essential to have a good policy-making process; one which has the governance, organisational and technical capacity to stimulate policy development and objectively assess policy proposals in the context of the needs of the real economy.

Notwithstanding the relative strength of our financial and regulatory system over the last 15 years, we have encountered shortcomings in our policy development process that need to be addressed to ensure that our financial system can continue to evolve in a manner that best serves the real economy and allows innovation and growth opportunities to be explored and to flourish.

Financial systems have evolved into complex sets of interrelationships. This complexity limits the capacity of administrators to intervene intelligently to improve interactions between market participants. This does not preclude government's capability to devise sound regulation that enhances the operation of the financial system but it does mean that it is a much more challenging task. Nonetheless, we have struggled in some areas of domestic reform to achieve a balance in policy setting and implementation that achieves the best outcomes for the financial system and the real economy.

4.2. Policy-making Capability

The financial sector needs policies that are designed and implemented to produce the outcomes in a cost-effective and efficient way. Reforms that raise the quality of supervision without excess burden contribute to growth in productivity, employment and income. In contrast, policies conceived without proper assessment carry risks of locking in productivity-sapping impacts and reducing the capacity of the sector to fund productive economic activity. The need for a high quality policy-making system requires further capacity building for each participant in the policy development chain.

Understanding the operation and functioning of the financial system is an essential step in the development of a sound policy and regulatory framework. Moreover, there is a need to keep the regulatory framework up to date with societal and technological developments, as discussed in Section 3. Effective policy development demands careful analysis of different options, drawing on available evidence. Good process is the key to ensuring that this happens, whether in developing new policies or evaluating existing programs.

Complexity Places Pressure on the Parliamentary Process

The traditional constitutional framework of policy-making suggests that politicians make policy and public servants implement it. In practice, this simple model is being overwhelmed by the complexity of the tasks being expected of contemporary law-making in a modern economy. It is an unremarkable observation to make that the total number of pages of legislation passed each year, and the average number of pages per Act have steadily increased over recent decades. The amount of delegated legislation has increased in parallel, both in terms of the number and length of regulations and administrative rules.[19]

The complexity of the financial system, as described above, means that Parliamentarians face a particularly difficult task in grappling with policy development in relation to financial products, institutions and markets. This situation is not unique to Australia and governments everywhere must deal with it too.[20]

One response may be to delegate greater policy-making authority to the financial regulators, or passively allow this to happen, and this has happened in Australia to some degree (as described below). However, this is inappropriate given the primary obligation of regulators is to implement policy, not to make it, and they have neither the organisational and technical capacity to develop policy, nor the ingrained culture required to achieve the level of objectivity required, especially where a balance needs to be struck between competing policy objectives (eg between competition and safety).[21]

The effective response is for legislators to maintain their policy-making authority and be able to rely on highly capable and objective policy advice to understand the implications of the laws they are making. This does not mean that Parliament should sign off on every rule that applies to the financial system – this would be an impossible task. Rather, it does mean that financial regulators administering the law receive clear and precise policy direction from the Parliament and design and implement rules to achieve this policy outcome. This process places a significant responsibility on the Commonwealth Department of the Treasury (Treasury) as the key public service provider of policy advice in relation to financial services.

[19] It is important to note that the increased length of Acts is not automatically and in itself a feature of complex legislation. Shorter Acts can be even more complicated than long ones as they may not include all the detail and explanation required for the law to achieve the policy objectives effectively. A short Act that requires the user to go to a complicated set of regulations or regulator’s rules is not, overall, a simplifying measure.

[20] For instance, as far back as 1960, the academic and former Chairman of Securities and Exchange Commission in the US, James Landis made a similar observation in respect of the United Sates in his “Report on Regulatory Agencies to the President Elect”.

[21] In the US context, Landis (above) went on to say that “the legislative standards under which the delegations are made are similarly increasingly loosened so that not infrequently the guide in the determination of problems that face the agencies is not much more than their conception of the public interest”.

Good Treasury Policy Advice is Essential

Good quality policy advice is essential for the well-being of our financial system and, therefore, for the other areas of our economy.

The search for better policy-making process is a core goal of public sector management. Much of the search has involved promulgating generally applicable 'principles' and procedures that are intended to represent good practice. This has been associated with recommending the introduction of new structures, systems, and processes that should be followed. Following the financial crisis, the OECD issued just such a set of "General Guidance and High Level Checklist"[22]. In Australia there have been several official publications providing 'guidance' for better policy-making including publications from the Australian National Audit Office[23]. In common with such guidance, these describe the steps in developing policy but do not always provide help in developing the content.

However, a set of principles or fundamentals for policy-making will not of itself guarantee that better results will be delivered and outcomes will be achieved. There are other factors at work, including management capacity, supporting systems and structures, good strategies and performance benchmarks, and effective communications and complaints handling mechanisms. These factors relate to management and organisational capability.

It is this last point of organisation capability where Australia's policy-making ability in relation to the financial system has weakened in recent years. Under current government arrangements this function sits in the Treasury. In our experience, Treasury officers are generally highly competent but due to budgetary constraints this capability has been reduced. This can lead to undue reliance being placed on the resources and experience of the tax and regulatory administrators in the formulation of policy and design of associated law and these agencies themselves are important stakeholders in the policy process. The pressure on Treasury resources also causes delays in tax and regulatory matters being given appropriate policy attention.

In contrast to financial sector regulators who have up until this point received increased resources from Government (see Section 4.9 below), the capacity of the Treasury to play its fundamental policy-making role has been diminished leaving regulators short on the policy guidance required for coherent and integrated implementation of the law. In our view, this has made it more difficult to ensure that appropriate trade-offs in competing policy objectives have been struck.

It is important to retain an intellectually strong and well-resourced policy-making capability that is able to take a strategic top down approach to financial system oversight and law reform. Such policy-making needs to be not only financial system-wide but integrated into a whole-of-economy framework that coordinates with other policy on government revenue, competition and the pursuit of other national goals as the need arises such as is the case with infrastructure development.

[22] OECD, Policy Framework for Effective and Efficient Financial Regulation – General Guidance and High Level Checklist, 2010

[23] Australian National Audit Office 2001, 2006

In this context, there is a broad view in the financial services community that policy-makers are better informed if they have constant contact with market participants. Having policy-makers located in Sydney allows this to occur more readily. This idea should receive attention as part of considering how to upgrade the policy capability of the Government.

4.3. Council of Financial Regulators

The Council of Financial Regulators (CoFR) is the coordinating body for Australia's main financial regulatory agencies. CoFR aims to facilitate cooperation and collaboration between its member bodies; the Reserve Bank of Australia, APRA, ASIC and Treasury. Its ultimate objectives are to contribute to the efficiency and effectiveness of regulation and to promote stability of the Australian financial system. CoFR meetings are chaired by the RBA Governor, with secretariat support provided by the RBA.

In CoFR, members share information, discuss regulatory issues and, if the need arises, coordinate responses to potential threats to financial stability. CoFR also advises Government on the adequacy of Australia's financial regulatory arrangements.

Since 2008, CoFR has proven itself to be a vital component of our financial sector regulatory framework. In recent years, it has considered Australia's position on developments such as: strengthening the capital framework for authorised deposit-taking institutions (ADIs); strengthening liquidity risk management by ADIs; the regulatory framework for financial market infrastructures; resolution frameworks and shadow banking. CoFR provides the ideal mechanism by which to coordinate the cross-over policy issues across the regulators mandates.

CoFR provides an existing forum for cooperation in financial sector regulation which brings the relevant parts of government together. This existing arrangement can be built upon to provide the forum for core policy coordination of the financial sector regulators, within the Government’s broad policy objectives.

It is important that there be coordination of the financial sector regulators under a process that provides for coherent and integrated policy guidance to them. Various administrative arrangements could be considered to ensure that the Treasury is in a position to fulfil its core function to provide coherent and integrated policy guidance. For instance, the Government could consider giving the role of Chair of the Council of Financial Regulators to Treasury to provide core policy coordination of the financial sector regulators. This proposal is also predicated on our other recommendation that Treasury needs sufficient resourcing to do policy properly and have an upgraded capability.

4.4. Policy-making Process

There are usually several alternative solutions to a given problem or market failure. An efficiently designed regulation could be said to be the measure that rectifies the observed problem (market failure) at the lowest possible cost. Amongst other things, this requires the integration of a sound cost benefit analysis into the policy decision making process, so the effectiveness of new interventions/regulation is properly assessed.

Regulatory solutions are often ‘off-budget’ for the government, which reduces the practical incentive in the policy decision making process to ensure the most cost effective solution is identified and adopted. This can be an even greater issue during periods of heightened risk aversion, like the period post the GFC, or when regulation is increasingly seen as a panacea for many of society’s ills. Therefore, the policy decision making process needs to be disciplined.

Policy-makers need to identify the source of market failures first and then design regulations to specifically address those failures. Furthermore, striking the right balance among goals, such as reducing systemic risk, protecting innovation, and maintaining acceptance by the community through the political process, is an important priority for the design of these policies.

Frameworks for assessing whether regulation in an area is necessary or appropriate should be a key part of any government’s policy assessment framework. It is appropriate that they be applied at multiple levels including within ministerial and cabinet processes before proposals are developed by departments and agencies. There have been many worthy efforts in this regard over time including “Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business” by the Federal Government in 2006. In particular Section 7.1 of the Report – “The principles of good regulatory process” provides some good basis principles to ensure less regulation is made or retained and is of higher quality:

i. Governments should not consider introducing or amending regulation unless a case for action is established. What is the problem being addressed? Why are existing regulations inadequate to deal with it? Why are (additional) measures warranted? In considering these questions, it is important to recognise that not all ‘problems’ will justify (additional) government action. For example, it will generally make more sense to accept a certain level of risk than to implement measures that seek to minimise or eliminate all risk.

ii. Where a *prima facie* case for action is established, a range of feasible policy options need to be identified and their relative merits rigorously assessed. This should include assessing the costs and benefits of regulatory alternatives, including quantifying compliance costs and undertaking risk assessments where appropriate. Self-regulatory and co-regulatory options also need to be investigated.

iii. The option that generates the greatest net benefit for the community (taking into account economic, social, environment and equity impacts) should be adopted. Importantly, this may not be the option that is easiest to administer. For instance, regulatory bodies often favour the control afforded by prescriptive regulation but principles based or performance based regulation will often confer greater benefits overall.

iv. There needs to be effective guidance to relevant regulators and regulated parties as the regulation is being implemented. Regulators need clear guidance on the policy intent of regulations and how they are expected to administer and enforce them.

v. There is a need for mechanisms, such as sunset clauses and periodic reviews, to ensure that regulation remains relevant and effective over time. These should en-compass removing regulation made redundant by changing conditions, or amending regulation to reflect new circumstances.

vi. There needs to be effective consultation with regulated parties at all stages of the regulatory cycle. It is important that stakeholders are consulted both at an early stage when policy options and approaches are being considered, and later when the detailed design features are being bedded down. Stakeholders also need to be consulted when regulation is reviewed or reformed after implementation.

BOX 4.1 – International Principles for Better Regulation

The challenge of delivering high quality, cost effective regulation is not unique to Australia and we can learn from experience overseas. AFMA contributed to the creation of a set of principles by the International Council of Securities Associations (ICSA) to promote better regulation. The ICSA Principles are a useful checklist in determining the appropriateness of regulation. The Principles broadly state:

- There should only be regulation where there is a significant market failure which is not addressed by existing regulations and that is unlikely to be resolved by market forces.
- Regulation should only proceed where it satisfies a cost benefit analysis that considers the full range of options including no action, the stimulation of competition, self-regulation and joint initiatives including improved guidance.
- Regulations should be targeted, proportionate and risk based. They should be framed in terms of principles rather than hard-wired and should stimulate and not restrict competition.
- There should be good consultation before implementation, review after implementation, sunset clauses where arrangements are expedited and coordination where there is jurisdictional overlap.

It is AFMA's experience that poor regulatory outcomes can generally be said to fail to satisfy at least one of these principles.

Note : The ICSA principles are available at - http://www.icsa.bz/img/letter_pdf/PrinciplesBetterRegulation.pdf

4.5. Role of Regulators in Policy Development

Regulators Role as a Stakeholder in Policy Development

A clear articulation of the roles of the policy-makers and regulators is needed to ensure that the lines between policy-making and implementation are well defined.

As a general rule, it is inappropriate for regulators to drive substantial policy changes. Regulators are not ideally placed to ensure that a balanced outcome is achieved, as by their nature they are an active stakeholder in outcomes. This is not to deny the appropriateness of their full involvement in a policy development process based in a government policy department/body that is an independent arbiter of competing policy objectives.

Regulator Independence

It is important at this point to emphasise that the matter of keeping a careful separation between policy-making and administration of the law is quite different to the matter of regulator independence.

The notion of 'regulator independence' is regularly cited as a high level objective in evaluating the effectiveness of financial regulatory systems. This takes up the traditional theory of the politics-administration dichotomy. This dichotomy is based on addressing the concern that the political environment is more susceptible to capricious and selective influences on decision-making, particularly when decisions are administrative in character and concern particular persons or small groups, than an administrator who is insulated to some degree from such influences. For this reason administrative decision-making is devolved into a regulator that is separate to the administrative level serving the political/executive component of government.

This administrative separation from the policy-making role is an entirely appropriate arrangement. A healthy system ensures there is a transparent arms-length relationship between law making and administration of the law through public dialogue rather than internalising rule-making inside a regulator where it can be subject to organisational dynamics and conflicts of interest.

Regulators as Effective Administrators

Within the framework this politics-administration dichotomy, delegation of detailed rule-making to a regulatory authority is compelling because no strategic policy-maker is able to foresee all policy issues that might be encountered in practice. It is commonly argued, when laws are being created, that regulators should be allowed the flexibility needed to adjust to inevitably changing circumstances. Markets and circumstances evolve with time and it is prudent to enable regulators to make appropriate incremental changes. It is also argued that policy-makers are not prescient. It is not possible for them to anticipate all issues that require policy-making to resolve. Rather than attempting to manage all technical details, delegation of authority to regulators to fill in policy details is deemed to be a pragmatic way to deal with complex issues.

Consequently, there is often an acceptance of policy-making that will have to be done when unanticipated issues arise for which there is no pre-existing policy, or where the policies, articulated in broad terms, requires clarification or fuller definition in application.

The difficulty of this situation is the risk of 'mission creep', as regulators relying on their delegated rule-making powers for handling detail may seek to extend the law beyond the intentions of political policy-makers. Where financial markets are concerned such rule-making can result in substantive interventions in the way markets operate without a conscious public debate occurring through a moderated political process to determine that the right policy is being adopted. Accordingly, the delegation of rule-making powers to regulators must be done in a way to manage this risk.

4.6. Policy Guidance for Regulators

In a world where regulators are being asked by their communities to do more and more and intervene in many aspects of social and economic activity, their good governance is a matter of vital importance to the well-being of societies. In the same way that modern communities expect regulated entities, such as financial institutions, to meet high standards of behaviour, accountability and efficiency, regulators must also meet such expectations. Given the power granted to regulators, it is important that their governance and performance is open to effective public scrutiny and debate.

Following on from the discussion about the need for regulators to implement and administer the law and not to make the law, it is worth considering what mechanisms may assist clarifying such understandings. The principles dealing with clarity around roles play an important part in ensuring that regulators have a clear understanding of their role. The use of 'Statements of Expectations' is a useful tool in assisting in achieving clarity on policy objectives and boundaries.

Following the recommendations of the Uhrig Report[24] the Australian Government agreed that Ministers would issue Statements of Expectations to statutory agencies. Through issuing a Statement of Expectation, a Minister is able to provide greater clarity about government policies and objectives relevant to a statutory authority, including the policies and priorities it is expected to observe in conducting its operations. The Statement of Expectations process clearly delineates the role of policy-making from that of independent administration of statutory responsibilities.

In order to demonstrate understanding and commitment to the expectations of a Minister, a statutory authority is required to respond to the statement. The response, a 'Statement of Intent', outlines how the authority intends to undertake its operations, and how its approach to operations will be consistent with the Statement of Expectations. Within the powers available, the Minister can seek a modification of the Statement of Intent if it did not address expectations sufficiently.

While there has been follow through on the once off preparation of Statements of Expectations for financial sector regulators, they have not been reviewed in accordance with the recommendations of the Uhrig Review.

In 2006 the Taskforce on Reducing Regulatory Burdens on Business[25] found that regulators need clearer guidance about the policy intent behind regulation, including in enabling legislation, and that ministerial Statements of Expectations should also facilitate this. The Taskforce noted that this would be of particular benefit in guiding the financial market regulators. The responsiveness of regulators to the need for a balanced approach would be reinforced by annual reporting against a wider range of performance indicators that reflect this balance.

[24] Commonwealth Government, Review of the Corporate Governance of Statutory Authorities and Office Holders (commonly referred to as the Uhrig Report), 2002

[25] Australian Government, 'Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business' 2006, p viii.

Statements of Expectations and Intent should be subject to review more frequently; perhaps annually. For instance, a review of the documents would be warranted if a new Minister or a new head of the authority were to be appointed or if there were to be a shift in government approach in a relevant area.

In summary, it is important to emphasise the distinction between policy-making and creating law from the administration of law by a regulator. Regulators should be assisted by having clearly defined roles and statements on what they are expected to do within the terms of government policy.

4.7. Regulator Accountability

Regulators exist to achieve objectives deemed by the Government to be in the public interest. They operate within and in accordance with the powers conferred by Parliament. Therefore, a system of accountability needs to take account of the performance of regulatory duties. Regulators do report regularly to Parliament and the responsible ministry in their policy area on the fulfilment of their objectives and the discharge of their functions, including through meaningful performance indicators. Parliamentary oversight by its nature is only fleeting and prone to extraneous influences from the political realm rather than thorough inquisition.

The Taskforce on Reducing Regulatory Burdens on Business observed that many business groups considered that the culture and behaviour of regulators were compounding the problems they faced with regulation itself. The landscape for financial services regulation is inherently more complex, with supervision and enforcement more intensive since 2008, so these issues may be potentially more pressing now. In the Taskforce’s view, regulators, like anyone else, will respond to the incentives in their operating environments. As indicated above, these influences have tended to promote unduly risk-averse approaches. Changes are needed to promote a more balanced approach. There is also scope to improve the way regulators interact and consult with business.

The OECD[26] has recommended that regulatory agencies should be subject to independent review of regulatory decisions especially those that have significant economic impacts on regulated parties. The Uhrig Report found that the operations of regulatory authorities can have significant impact on the community including business. To preserve necessary areas of independence, the scope for ministerial direction of such authorities is limited by their enabling legislation. A perhaps unintended consequence is that regulatory agencies are not subject to the same degree of accountability for the way in which they exercise their statutory powers as service provision authorities.

To address this concern, Uhrig proposed that an Inspector-General of Regulation be established to review, independently, a regulatory authority’s systems and procedures for the administration of legislation. Naturally, such a body would need to be properly resourced to fulfil the Government’s objectives for it. While this recommendation proved to be expansive in scope for practical implementation the idea was taken up with the creation of an Inspector-General of Taxation (IGT).

[26] OECD, Recommendation of the Council of the OECD on Regulatory Policy and Governance, 2012, p28

The IGT, established in 2003, is an independent statutory office that reviews systemic tax administration issues and reports to the Government with recommendations for improving tax administration by the ATO (on the basis that it generally adopts the IGT's recommendations) for the benefit of all taxpayers. AFMA has made input to a range of reviews conducted by IGT and has formed the view that the IGT makes a significant and beneficial contribution to the effectiveness of tax administration for Australian business.

Examination of the idea of creating an Inspector General of Financial Regulation to review the work of the financial sector regulators has merit.

The Taskforce on Reducing Regulatory Burdens on Business also said[27] that each regulator should have a code of conduct setting out the rights and responsibilities of the agency and those it regulates, and report annually against it. This idea also has merit as part of improved stakeholder accountability arrangements for ASIC and APRA.

4.8. Industry's Role in the Regulatory Process

AFMA supports market-based solutions as sound mechanisms to create efficient outcomes for governments and societies across a wide range of activities. Such solutions include industry involvement in the regulatory process through industry best practice guidance and self-regulation, which has played an important role in the development of many financial services sectors. Indeed modern statutory rules find their antecedence in rules which were created out of mutual need by participants in the market.

Recently, pressures on self-regulatory frameworks have increased in markets worldwide. In much of the world, the value of self-regulation is being debated anew. Forces such as demutualisation of exchanges, development of stronger statutory regulatory authorities, and globalisation of capital markets are affecting the scope and effectiveness of self-regulation. In addition, the effectiveness of all financial regulatory systems is being re-examined in the aftermath of the international financial crisis.

While industry self-regulation cannot replace direct government regulation and supervision of the financial sector, only a system that successfully uses the potential benefits of greater industry involvement in the regulatory process can provide a long-term solution to the fundamental challenge that complexity brings. This is especially relevant to the wholesale financial markets, where sophisticated institutions are well placed to determine the terms on which they deal with each other, within the framework of the law. Without enlisting the industry's meaningful and active participation in the regulatory process, regulation will fall behind the dynamic nature of the market and its participants to move forward and innovate. They have a better ability to identify, analyse, and assess systemic implications of underlying trends in the financial markets, particularly regarding complex financial products and transactions through the simple need to successfully survive in business.

[27] Op cit, p viii.

Industry self-regulation needs to evolve to be more comprehensive and systemic in its scope and operation. The most recent financial crisis demonstrated that the most fundamental challenges facing financial regulators and policy-makers stem from the increasing complexity of financial products and activities and the globalisation of financial markets and institutions. Providing industry with a meaningful role in the regulatory process could serve as the key link allowing us to tackle two issues central to regulatory reform in the aftermath of the crisis: the critical role of timely access to market information, on the one hand, and the need to monitor and manage risk across jurisdictional borders, on the other. Market participants are in the best position to identify and understand underlying trends in the increasingly complex financial markets and to gather and analyse, in real time, information most relevant to systemic risk management.

Industry involvement in the regulatory process, including through self-regulation in appropriate cases, should form part of the future regulatory fabric of the Australian financial system. This has the capacity to improve market efficiency, give better regulatory outcomes and reduce the cost of regulation for business.

4.9. Regulatory Burden and Regulators

Regulation may bring benefits but it also involves costs. The costs of regulation can go beyond those borne by those directly affected by the regulation, the industry being regulated or its customers - there may also be costs in the broader economy, for example, when a regulation reduces innovation that would otherwise improve the functioning of the economy. For instance, the financial sector is being subject to an unprecedented wave of regulation that is being implemented at great speed. Amongst other things, this raises barriers to entry, which may create perverse outcomes for competition, as smaller businesses and new entrants may be discouraged by both the scale and complexity of regulation given their more limited resources. Bearing in mind these types of effects, costs can in some cases exceed the economic benefits that could be expected from regulation. Therefore, it is essential to optimise regulation by weighing its costs against its benefits.

4.9.1. Paying for Regulation

The significant recent growth in cost recovery from the industry and the absence of rigour and discipline in the policy and practical basis upon which this is determined is a matter of concern from a financial system efficiency perspective. In some instances, there is not a good basis for a cost recovery charge, as there is no direct service provided to the payer.

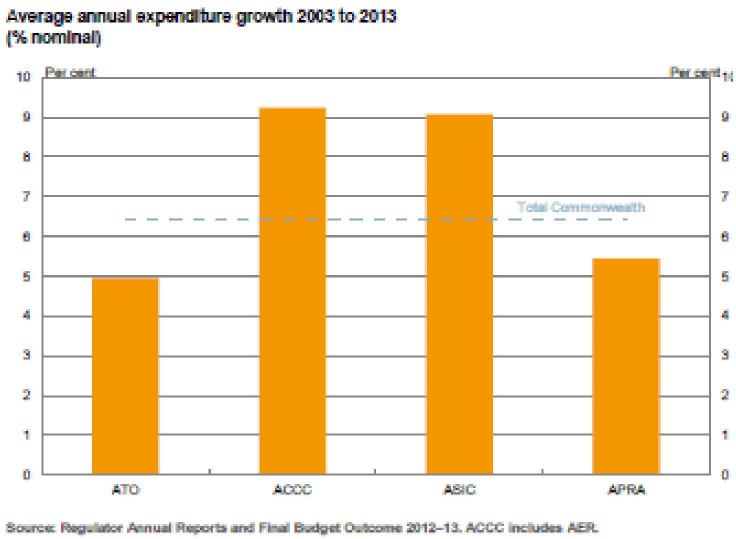
The financial sector is one of the most heavily regulated areas of business activity in Australia and is a major contributor of direct tax revenue to the Government, which is estimated at about $25 billion per annum. Beyond direct tax revenue the sector also bears a heavy non-tax revenue burden. In addition to a rapid escalation in the costs of compliance there has been a significant increase over the last decade in the number and amount of non-tax revenue items in the form of fees, charges and levies imposed on financial institutions. In the financial year ended 2012, three of the financial sector regulators raised net revenue for the Government of $322 million on the basis of comparing non-tax revenue collected by the agencies to budget appropriations.

TABLE 4.1 – Selected Regulators Net Revenue Contribution to Government 2012

Agency	Non-tax revenue $ mn	Appropriation $ mn
ASIC	663.6	319.3
APRA	131.9	119.2
AUSTRAC	27.8	63.1

The introduction of the GST was designed to replace a range of indirect taxes and remove inefficiencies. Since, then a number of charges that are inefficient and in the nature of quasi-taxes have been placed on the financial sector under the mantle of cost recovery.

FIGURE 4.1 – Annual Expenditures for Selected Regulators



Source – Business Council of Australia

Meanwhile, the expenditure of financial sector regulators has grown at a rate in excess of Commonwealth expenditure and well above the inflation rate over the last decade.[28]

Cost recovery for regulation presents a significant 'moral hazard' for government because the incentive to have proportionate and efficient government regulation is diminished by the fact that the government itself does not have to pay for this regulation. Meanwhile, the business entities that must pay the levy have no control over the cost process. Whatever the design of cost recovery mechanisms, in practice they invariably lead to inequities in who pays, often lead to significant administration costs and can create inefficiencies in markets.

There has been a significant growth recently in government charges and levies on industry participants ostensibly to cover the cost of their regulation, which exacerbates the strain on the

[28] See Business Council of Australia - http://www.bca.com.au/publications/reports-and-papers

industry already implementing substantial, high cost regulatory reforms. In practice, some of these charges operate in a manner more akin to a tax on financial transactions.

When government policy dictates cost recovery, the process for establishing and reviewing recoverable costs should fit within a coordinated policy framework that takes into account the economy-wide impact of multiple service charges, which are growing in number.

4.9.2. Assessment of Overall Economic Impacts

This leads us to the overall ad hoc nature of the cost recovery process across the financial system and the cumulative effect that a multiplicity of new regulation is having on the efficiency of Australia's financial markets. New government regulation and charges that increase friction in conducting financial transactions affect how business views the competitive environment and the relative attractiveness of doing business in Australia compared to other jurisdictions. We believe that the government process for establishing and reviewing recoverable costs should fit within a coordinated economic policy framework that takes into account the economy-wide impact of multiple service charges.

New government costs and charges are an impost on business that affects the competitive environment and the relative attractiveness of doing business in Australia, compared to other jurisdictions. Most charges associated with government activities, particularly those related to regulatory activities, are paid by firms rather than individuals. To the extent that they are then passed on to counterparties (including consumers), increased prices or a reduction in the range of products or services available will result.

Industry recognises that, when viewed in isolation, most regulation is reasonable; however the cumulative effect of all regulatory measures builds into a burden which exerts a drag on the economy. As a wide array of new rules are implemented – both here and internationally – it is important for the sake of our economic growth, investor returns, and the global competitiveness of the Australian financial services industry that the cumulative weight of new rules and measures, such as cost recovery, is understood. The aggregate burden of such measures is not readily apparent, as government does not have a coherent mechanism for monitoring and reporting on the totality of measures from a regulatory burden perspective.

Transparency and accountability are very important in ensuring that only the relevant supervision costs are funded through this process and also that any cross-subsidies are readily identifiable. The Productivity Commission (PC) in its 2001 report on cost recovery observed that:

> *Accountability and transparency are very important for government agencies, particularly where cost recovery may be creating incentives for undesirable practices such as regulatory creep, gold plating and cost padding or… However, in the absence of a standard institutional framework for cost recovery, accountability and transparency have suffered.*

> *This lack of transparency is particularly significant where the ability to raise cost recovery revenue reduces the level of budgetary and Parliamentary scrutiny of an agency.*[29]

The PC described these undesirable incentive effects of cost recovery in the following way. Cost recovery can create incentives for undesirable activities, including:

- Regulatory creep — where additional regulation is imposed without adequate scrutiny. Regulation impact processes may be followed less stringently when cost recovery is possible, and the burden of additional regulation may be underestimated when it imposes no net cost to the Government;
- Gold plating — where unnecessarily high standards or facilities are adopted. The ability to cost recover may allow agencies to impose their preferred levels of service, rather than the minimum necessary to satisfy clients or achieve government objectives; and
- Cost padding — where costs are artificially inflated, motivated by the knowledge that all costs can be recovered.[30]

4.9.3. Identifying Beneficiaries

An area of particular difficulty with much of the financial regulation cost recovery is the misidentification of "beneficiaries" to whom the user pays principle applies. Cost recovery measures find their roots in payments for services delivered by government that might otherwise be substituted by private sector providers.

For example, the Government finances a new road through a toll on road users or, in an example relevant to this industry, charges for the guarantee provided to banks. Under the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding, eligible ADIs could apply to the Scheme Administrator to be able to offer guaranteed large deposits. It is up to individual ADIs whether they chose to apply for this approval to offer guaranteed large deposits, and in turn, ADIs accessing the Scheme are required to pay the Scheme Administrator a fee based on the value of deposits it has covered by the guarantee and the credit rating of the ADI. In this case, there is a clear connection between the value of the service being provided by the Commonwealth and the cost charged to the user ADI and its customers which is fully justified and fair.

However, in relation to much of financial sector regulation, it is market intermediaries, not the "beneficiaries" of the regulation, who bear much of the cost recovery burden. Such is the case with funding for AUSTRAC and market supervision by ASIC through cost recovery.

With regard to AUSTRAC, financial market intermediaries devote substantial resources to assisting the Government in its task of recovering tax revenue, tracking flows of criminal funding and terrorist funding. AUSTRAC provides no direct services of value to financial market intermediaries or their customers and is purely a regulatory burden from a business efficiency perspective. The value of

[29] Productivity Commission, Inquiry Report – Cost Recovery by Government Agencies, Report No. 15 August 2001, p 181
[30] Op cit, p97 Box 5.1

AUSTRAC's activities is directed to broader societal goals harnessed by the Government for general well-being of the community, in a similar way to other policing and defence activities. No value is ascribed by the Government to the considerable resources and assistance provided by financial market intermediaries to the Government in this area.

The Government may be a significant beneficiary from regulatory change in other ways. For example, the introduction of competition for cash equities trading in 2011 generated new regulatory costs that the Government declined to accept and, instead, it placed a regulatory charge for full cost recovery on the industry. ASIC has observed that the competition is expected to give a reduction in overall costs of execution, due to tighter spreads and a reduction in transaction costs.[31] The available evidence suggests that competition generated significant cost savings for traders, which would have increased their profits and, thus, government tax revenue from this activity.[32] If account were taken of this benefit, then there may not be a case for any cost recovery in this situation. The key point is that it makes no economic sense to take an asymmetric approach that looks at costs only, when assessing the impact of a regulatory measure on the Government's bottom line.

4.9.4. A Coherent Policy Framework for Cost Recovery

The Government needs to introduce a coherent policy framework to determine if a cost recovery charge has a sound economic basis and, if so, that it sits within a coordinated policy framework that takes into account the economy-wide impact of multiple service charges.

The current activity-by-activity approach makes the cumulative impact of regulation difficult for the public and policy-makers to measure when working within the confines of their own portfolio responsibilities. There should be a cohesive and consistent policy for cost recovery oversight and governance which goes beyond the existing Guidelines in Finance Circular 2005/09. This would allow the overall micro-economic impact of charges across the economy and particular sectors to be assessed and taken into account. Instead of a piecemeal activity-by-activity approach to new cost recovery measures, they should be developed by financial experts with appropriate modelling and quantitative skills to correctly measure inputs, outputs and costs and to provide an assessment of their impact on productivity. This would include rigorous analysis to determine if there is a valid case for cost recovery in respect of a particular charge or proposed charge, having regard to the range of beneficiaries of the regulation, the potential impact on financial system efficiency of the charge and the costs involved.

Cost recovery measures should be subject to effective governance and accountability arrangements to ensure that administrative costs are reasonable and contained over the long term. Attention needs to be paid to the general policy concern that without effective checks and balances in the design of the system, the ability to cost recover can make it easier for agencies to justify inefficient

[31] See https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/10-227MR-Background.pdf/$file/10-227MR-Background.pdf

[32] For example, see https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Market-Supervision-Cost-Recovery-Impact-Statement-July2013-June2015.pdf/$file/Market-Supervision-Cost-Recovery-Impact-Statement-July2013-June2015.pdf.

practices, because by virtue of making no net call on the government budget they do not face the same level of official scrutiny. The ability to raise revenue that is deemed to be partly sheltered from budgetary and Parliamentary scrutiny because of its dedicated sourcing and application reduces incentives to be cost effective.

SECTION 5 – Australian Financial Regulation in a Global Context

KEY POINTS

- International standard setting bodies have a major influence on the rules of the global financial system, and in turn national financial system policy. Australia, as a stakeholder in this process, needs assurance that their governance and accountability structures are satisfactory from a political economy perspective.
- The industry needs globally consistent standards and rules that allow financial institutions to provide services to meet the real economy's evolving needs, without introducing unproductive activities.
- Australia should have the policies and processes in place to protect our national interest in international fora.
- Australian regulators should continue to be active participants in international standard setting bodies, so we are influential insiders in their decision-making processes. Our experience is that this can produce improved outcomes for Australia. In this capacity, regulators have to step beyond their narrow interest as an administrative body and argue for the broader policy objectives of the Government.
- Proposals to adopt international norms should require as much scrutiny and analysis as occurs in the domestic policy development process. In this regard, Australian policy-makers and regulators should make decisions and confidently utilise national discretion features as necessary to serve the interests of our financial system, the international competitiveness of our financial institutions and the economy.
- The ongoing development of Asian financial markets is important to support future economic growth in the region. Australia has a common interest with Asian countries in ensuring that the global financial standards are appropriate to the region. It is important that an Asian perspective be taken into account in bodies like the Financial Stability Board and the Basel Committee.

5.1. Introduction – International Influence on Policy

Given the rapid evolution of regulation surrounding the global financial system over the last five years and the role of the international standard setting bodies in this, there is a need to think in a more deliberate way about whether the hurriedly developed international administrative arrangements put in place during the GFC provide an appropriate framework going forward. International standard setting bodies have a major influence on the rules of the global financial system, and in turn national financial system policy, but they do not have the calibre of political public policy oversight and accountability that govern national regulators.[33] We need assurance that their governance and accountability structures are satisfactory from a political economy perspective.

The global response to the GFC has been a decisive shift to more interventionist models of financial regulation, as evidenced by measures adopted in the US, Europe and elsewhere. These reflect individual jurisdiction's approach to regulation of their financial sectors, including their particular interpretation of G20 agreements, and also new and revamped international regulatory standards issued by the International Organisation of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BCBS). Attention needs to be directed at the application of international standards by national regulators and the impact of extra-territoriality of their implementation measures on our financial system.

5.2. The New International Supervision Framework

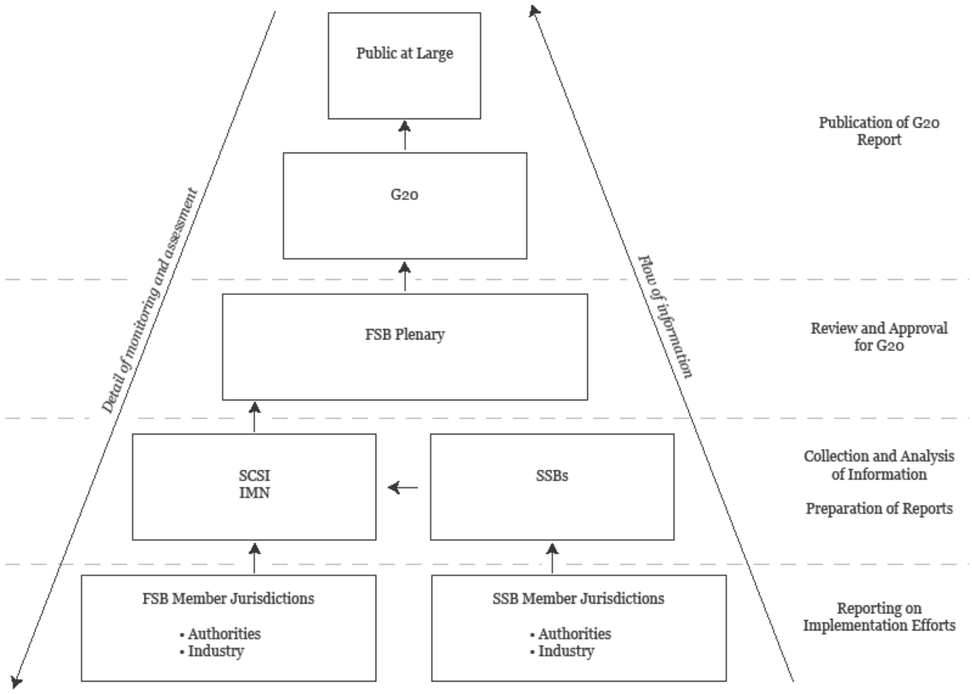
The measures put in place by the G-20 to deal with the global financial crisis created important international administrative arrangements through the establishment of the Financial Stability Board (FSB) for coordinating at the international level the work of national financial authorities and international standard setting bodies and for developing and promoting the implementation of effective regulatory, supervisory and other financial sector policies.[34]

[33] The term 'international standard setters' is used to distinguish these comments from the more traditional debate around supranational bodies operating within political compacts where national powers are handed up to a central authority, such as in the European Union.

[34] The predecessor of the FSB was the Financial Stability Forum a typically informal institution, without a legally binding charter, with only developed countries as members.

FIGURE 5.1

Structure of Information Flows for G20 Reporting



Source: FSB 2011

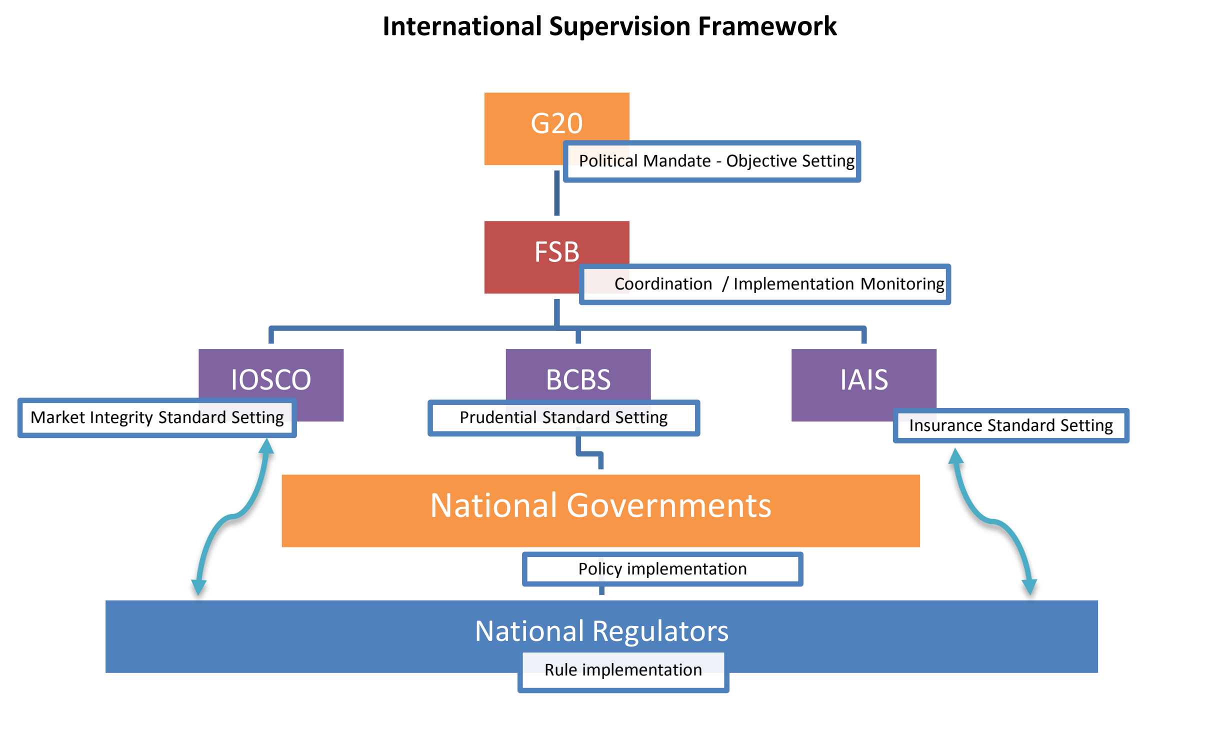
The FSB succeeded the Financial Stability Forum and helped the G20 to implement the new financial regulatory rules. At the G20 Pittsburgh Summit in September 2009, the leaders agreed to set up the FSB charter, which included the mandate, organisational structure and working practices of the new international organisation. This indicated the desire of the G20 leaders to formalise the institution. Generally, formalisation includes three dimensions: obligation, precision and delegation.

- *Obligation* means that the institution is legally bound by rules or commitments and therefore subject to the general rules and procedures of international agreements.
- *Precision* means that the rules are definite; unambiguously defining the conduct they require, authorise or proscribe.
- *Delegation* grants authority to third parties for the implementation of rules, including their interpretation and application, dispute settlement and possibly further rule-making.

One obligation, in the case of countries, is to participate in a financial sector assessment programme (FSAP) every five years and to publicise the detailed assessments produced by the International Monetary Fund and the World Bank and use these as a basis for their reports on the observance of standards and codes (ROSCs). A second obligation is to implement international financial standards, including new standards created by the FSB.

Besides participating in FSAPs, FSB members undergo two kinds of peer review: a thematic review and a country review. If the FSAP could be considered a comprehensive test, then the thematic and country reviews are specific tests. The FSB publishes the much more precise compliance report, along with a designation of fully qualified, basically qualified, basically unqualified or fully unqualified entities.

FIGURE 5.2



The FSB has its own secretariat, which plays an important role in setting the agenda and implementing the requirements. It works through its plenary meeting and steering committee, as well as standing committees on assessment of vulnerabilities, standards implementation, supervisory and regulatory cooperation, and budget and resources, and several regional consultative groups.

Our purpose here is not to critique the technical work currently being carried out by the FSB in conjunction with global standard setters such the BCBS and IOSCO but to think critically about the effectiveness of current oversight and accountability arrangements from a national interest perspective. Globally, FSB under the authority of the G20 plays a coordinating role in the global implementation of reforms to OTC derivatives markets.

The important issue from an industry perspective is that the implementation of global objectives, such as trade reporting mechanisms and mandated infrastructure, allow financial institutions to provide services to meet the real economy's evolving needs and does not introduce distortions which send financial market activity off into unproductive activities. This is why sensible, globally consistent standards and rules are strongly desired by industry.

The FSB and the global standard setting bodies should be given every encouragement and support to develop standards and rules that can be implemented by national authorities in a way which is consistent with international practice. If they lack a broad range of views when developing such standards and rules, it makes national implementation much more difficult in places where local issues have not been properly taken into account.

5.3. General Political Legitimacy

Just as transparency, accountability and community oversight are important requirements for financial market participants, so should global financial standard setters be transparent and accountable in their rule-making to political controls.

The G20's goal of addressing key systemic risk issues cannot be met without international coordination on market infrastructure, market transparency and counterparty credit risk. However, international regulatory standards to achieve this are subject to less policy scrutiny and regulatory impact assessment than domestic regulatory measures. Moreover, the importation of international standards to national regulatory regimes in some cases can by-pass or lessen the usual review processes for a new policy measure, when it is to be implemented as an external norm by a jurisdiction.

In this situation, it is important for there to be appropriate checks and balances in the international standard setting processes to ensure that standards are fit for purpose and will improve the situation for the economy. This is an area that warrants further attention as the international regulatory system develops.

The arrangements for governance of international standard setters should be guided by the same principles of transparency, predictability, participation, reasoned and timely decision-making, and accountability as are applicable to jurisdiction-based regulators. This means that they must conduct their operations pursuant to transparent procedures that result in decisions and actions that are predictable and understandable to all stakeholders. They must also offer these stakeholders some meaningful way of raising their concerns and having them addressed by the international standard setters. Finally, the stakeholders should be able to hold the institutions accountable for their decisions and actions.

5.4. Effective Australian Interaction with the International Framework

Government

Legitimised by their own domestic authority, G20 leaders, supported by their Finance Ministers, can use their influence in this and other fora to advance broader international policy coordination. The Australian Government should discuss with other governments the broader issue of policy governance and ensure political legitimacy for the actions of global standard setters. Setting priorities and a concrete and relevant agenda, first and foremost in the economic and financial sphere of governance is an important objective. The Government should continue to represent Australian priorities and concerns in international discussions, utilising the domestic policy development processes discussed in Section 4 to determine its position. This may in some instances require supplementary consultation in relation to some specific G-20 proposals; for example, if they relate to issues applicable to other jurisdictions and have not been considered in detail in an Australian context.

Australian Regulator Participation

Providing effective governance for international standard setters provides greater challenges than in the domestic context. International standards are typically developed by a small group of technical specialists from jurisdictional regulators, who work together in international fora without the same level of external governance checks and balances that would apply if they were developing such standards in their home jurisdiction. On the assumption that transparency and political scrutiny result in higher quality public policy outcomes, the current global financial system regulatory arrangements need to be appraised as to whether they allow sufficient community transparency and scrutiny.

Australia needs to ensure that we have the policies and processes in place to reasonably protect our national interest in these fora. In particular, Australian regulators should continue to be active participants in international standard setting bodies, so we are influential insiders in their decision-making processes and, thus, well placed to influence the outcomes. Our experience is that this approach can produce improved standards from an Australian perspective.

Australian regulators should participate in the international standard setting bodies with a clear sense of purpose to promote standards that can be implemented in a manner that best meets the specific needs of the Australian financial system and economy and seek appropriate refinement of standards that might frustrate this. This requires regulators to step beyond their narrow interest as an administrative body for regulation and argue for the broader policy objectives of the Australian Government and economy.

There needs to be processes both to assist regulators in this endeavour (for example, through discussion with Treasury as the key policy agency) and to provide proper oversight of their effectiveness in this regard. Australian representatives from regulators should be formally accountable to the Government in relation to their participation in international fora and operate in accordance with government policy settings and instructions.

The Government itself has a role in this regard by signalling a clear expectation that regulators must represent the national interest in their international work. This could be done through the Statement of Expectations discussed above and could form part of a regular review of a regulator in accordance with the Statement.

We have a solid base to build on, as Australian's regulators are active participants in international standard setters such as the BCBS, IOSCO and Financial Action Taskforce (FATF). The high level of influence they have achieved is striking and has in some instances enabled us to positively influence outcomes on important issues to the benefit of the economy. The framework we suggest here would leave us better placed to consistently promote our national interest to good effect in these fora. The economic costs of poor regulation can be very high in economic terms, so the benefit from applying resources to this exercise is significant.

Adopting International Standards

One of the challenges for regulators to manage when participating in international fora is the natural desire as an insider in the process to be a full and early adopter of standards or guidelines that are produced by the international body. This approach may, or may not, be appropriate to the Australian economy depending on the nature of the standard and the particular needs of our financial system and economy, so judgement needs to be made objectively and solely on this criterion.

For example, reflecting the open nature of the Australian economy and the associated large inward and outward corporate business flows, Australian financial institutions have significant business operations in global banking and financial markets and many foreign regulated institutions operate in the Australian market. Against this backdrop, the approach taken by Australian regulators to the incorporation of international standards into the Australian rules can have important competitive implications for the Australian industry – see Box 5.1.

Therefore, in exercising judgement in this area, the Australian regulators should seek to ensure that the institutions they regulate are not disadvantaged by the manner in which Australia adopts international standards, unless there is some significant deficiency in those standards as they would apply in an Australian context. In the latter case, the regulators should endeavour to have the international standard revised as necessary to achieve the underlying regulatory objective.

BOX 5.1 – International Competitiveness and the Adoption of International Standards

Regulatory neutrality is particularly important in the case of banking, given the international nature of the market.

APRA as the prudential regulator for ADIs requires the locally incorporated Australian banks to maintain certain levels of capital to manage risks. The Basel Committee on Banking Supervision (Basel Committee) has recently assessed APRA's regulatory regime for banks and its assessment team reported that some aspects of Australia's capital regulations, such as those related to the definition and measurement of capital, are more rigorous than required under the Basel Framework. APRA has also implemented some aspects of the Basel III Framework ahead of the internationally agreed timeline and has also decided not to opt for the extended transition period for Basel Framework implementation.

Consequently, APRA's capital standards are more conservative than the standards set by the regulators in almost all of the leading banking jurisdictions. This has competitive implications for Australian banks because they generally must apply a higher amount of capital to their financial market and wholesale lending transactions. For example, when pricing an interest rate swap for a corporate client, Australian bank must look to recover the cost for a higher amount of capital attributable to the transaction than would an international bank that is competing for the same business. The impact of this is material in a market where spreads are very tight and competition is robust.

The strength of a financial institution will depend in part on the success of its business, provided this is conducted in a prudent manner. APRA's approach places Australian banks at a competitive disadvantage in financial markets business, but also in areas like trade finance and lending, relative to banks whose regulator is adopting the new Basel framework in line with the Basel Committee's phase in arrangements and in accordance with capital requirements under the framework.

More generally, international standards can require significant changes to business practices and impose considerable costs on the economy, so proposals to adopt international norms should require as much scrutiny and analysis as the national policy development process. There should not be a default position to adopt these standards as a matter of course, as this would weaken the capacity of our governance system to promote the best outcomes for our economy.

Effective domestic critical policy appraisal needs to go into the process and pace of adopting international norms. Their adoption should be in accord with the national interest and in a way which suits Australian conditions. Experience has shown that it is often better to wait to let others sort out implementation problems and learn from their mistakes as the most efficient way to put in place new rules.

We expect that international standards would generally be appropriate to the Australian financial system and, therefore, the approach we suggest would not dramatically alter current outcomes. However, as explained above, there would be situations where the timing or form of adoption of an international standard in Australia would make a material difference to the economic cost and effectiveness of our financial system and our decision making process must place greatest weight on the right outcome for our economy.

In this regard, it is relevant to note that international standards often contain a national discretion feature that enables modification of the standard, or a proportionality judgment to be made about the application of the standard, in particular national economies. Australian policy-makers and regulators should confidently utilise these discretions when it is in the interests of our economy to do so.

5.5. The Challenge of Integrating Global Regulation

Governments and international financial standard setters face a number of substantial political and practical problems in establishing a globally harmonised regulatory process. The first challenge is to redirect the existing international and various national regulatory systems, which are a product of rapid GFC driven reforms, so that they operate with greater cohesion.

In the absence of an effective global framework, the immediate legislative and regulatory responses to the GFC was resolutely national or, at best, regional. Although some convergence in approaches has been facilitated by the principles and standards developed by the international standard-setting bodies, national implementation of the GFC-related reforms has generated both differently-paced implementation timetables and substantial divergences in the manner in which global reforms are being applied.

In particular, practical problems are starting to multiply as new regulatory reforms are implemented with extensive extraterritorial consequences. For example, the European Union is making increasing use of the concept of 'equivalent' regulation, which in practice requires that regulators from all other jurisdictions must engage in extensive discussions with EU regulators in order to demonstrate that their own regulatory regimes are 'equivalent' to the European regulations being put in place so that their market participants have access to European markets. Similarly in the US both the Foreign Account Tax Compliance Act (FATCA) and the Volcker rule have extensive extraterritorial consequences.

National regulators are concerned about regulatory arbitrage and a "race to the bottom" and counter it by attempting to ensure that other jurisdictions have roughly the same regulatory burdens as their own. One concern for national regulators has been to ensure that domestic regulatory reform does not disadvantage the domestic financial industry by deflecting business to overseas jurisdictions. As a result, international harmonisation of regulatory standards has traditionally been seen as the necessary corollary of domestic regulatory reform.

Despite expressions of policy intent and the flow of communiques, particularly between the various regulatory authorities in the US and the EU, the reality has been an increased momentum towards regulatory protectionism and extraterritoriality.

In part national regulators are concerned to guard against losses being transmitted through the global financial system without regard to markets or national borders. So the new international financial framework still has to face the challenge that national regulators act on the international plane with quite a nationalist view of their interests: other nations' markets are of concern primarily insofar as they pose financial risks to the domestic market or they become a potential source of competition for the domestic market because of lower regulatory standards. In response, it is argued that it is necessary to push for global harmonisation and standardisation over national diversity in regulatory approaches, that is, to favour harmonisation rather than pluralism as a modality of international legal architecture.

Global agreements require domestic support for implementation, but in many jurisdictions domestic constituencies, from legislators to market participants, have proven to be antagonistic to newly harmonised rules. The consequence is often the practical impossibility of creating genuinely internationally harmonised rules.

There is acceptance that financial institutions operating globally can be a vehicle for the importation of extraterritorially sourced risks which can have real adverse consequences for domestic markets, financial service providers and consumers. However, vulnerability to global contagion is better mitigated through the adoption of harmonised minimum thresholds in international regulatory policy and standards, better and deeper real time cooperation and supervision and comprehensive information-sharing between regulatory and supervisory authorities. This, in turn, will require a restoration of trust and confidence between regulatory authorities in different jurisdictions.

OTC derivatives regulation is an area that particularly demonstrates the pressing need for global action in order to ensure that there is consistency and coordination between the regulations being put in place in different jurisdictions – see Box 5.2. In the light of regulations that have been proposed and in some cases approved, banks and other financial institutions which undertake significant cross border activities in OTC derivatives are concerned that they may be subject to overlapping and contradictory regulatory requirements in different jurisdictions and may need to comply with two or more different regimes.

BOX 5.2 – Inconsistent Global OTC Derivatives Reforms

The global drive for increased use of centralised infrastructure, as well as other reforms to OTC derivatives markets has been associated with a large number of international and national regulatory efforts. International standard-setting bodies have developed or revised standards and recommendations for OTC derivatives regulators, market participants and infrastructure providers in support of this transition.

These initiatives are designed to make the financial system safer, to improve investor protection, or to make it easier to deal with the failure of financial institutions. But they also impose costs on, and change the behaviour of, financial institutions, with consequences in turn for their customers, capital markets and ultimately for the real economy. These cost are significant if the reforms are internationally consistent, well-coordinated and smoothly implemented. However, they increase sharply when these conditions do not prevail, which is what has actually occurred.

The Commodity Futures Trading Commission (CFTC), the main regulatory agency in the USA charged by the Dodd–Frank Act to regulate a substantial portion of the derivatives market including clearing, settling and reporting of transactions, moved first in proposing and adapting rules, at times far ahead of other agencies and not always in coordination with key European and Asian counterparts.

US law and the CFTC have sought to deal with avoidance by regulating activities outside the USA. This has proved to be a vexing aspect of US financial regulation; while the CFTC continues to insist on broad cross-border regulation as a result of the mandate in Dodd–Frank, it has introduced the concept of substituted compliance to the equation, whereby it can exempt compliance with certain US rules if it deems host country rules sufficiently equivalent to those of the USA. The CFTC has also delayed requirements to comply with certain cross-border rules with the mechanism of no-action letters. Europe has followed a similar path with its European Market Infrastructure Regulation (EMIR) regime. As a result, international consultation and coordination of various cross-border rules in the registration, trade reporting and clearing context has become a significant aspect of cross-border business.

The effect of divergent regulations for OTC derivatives is to cause market participants to make decisions in relation to dealings in particular jurisdictions or with particular counterparties based on regulatory considerations rather than normal commercial grounds. Such divergences also have an effect on counterparty and ultimately end user choice and lead to increased costs. If differences are material, many firms are likely to gravitate away from an integrated global approach to business and structure their businesses around specific products with local counterparties in the relevant jurisdiction.

5.6. Comparability

The concept of comparability of regulation offers the most fruitful way forward to recognition of overseas regulatory regimes. Comparability reflects the fact that regulatory systems, overarching legal frameworks and market practices will vary significantly from jurisdiction to jurisdiction. However, progress towards achieving this outcome is slow.

To date much of the attention placed on addressing overlapping and contradictory national and regional regulation has involved bilateral negotiations between the US and the EU. While it is extremely important that the US and EU reach convergence or at least a high level of consistency in terms of their regulatory reforms. These negotiations alone are too limited and therefore do not adequately serve the goals of the G20 from a global perspective. One major problem with the bilateral approach to global regulatory convergence is that it ignores the rest of the world, which means that most jurisdictions in the world will need to prove that their own regulations are ‘equivalent’ to the regulations established in the US and/or the EU.

Instead, there needs to be a focus on the comparability of regulatory outcomes rather than on the sameness of rules. The test of regulatory comparability can be applied at three different levels, namely:

i. Comparability between national regulatory frameworks, which should be based on shared public policy objectives and common regulatory values, scope and outcomes, particularly in relation to systemic risk reduction and transparency;
ii. Rules comparability for the purpose of applying substituted compliance, but recognising the inevitability of certain key differences which cannot necessarily be reconciled because of differentiated legal systems, market practices, insolvency laws, etc. – and if and where key rules are deemed to be so divergent as not to accommodate substituted compliance, they should be the subject of a dialogue to assess the prospect of amendment and convergence;
iii. Comparability between national competent authorities in terms of their capability, resources and expertise in the area of supervision, investigation and enforcement (recognising that effective mutual reliance in this area is dependent on a high degree of trust and confidence between those authorities).

5.7. Counter-balancing North-Atlantic Policy Dominance – Asian Voice Needed

In terms of the extent and forms of interventions, the regulatory philosophy and the state of development of the individual markets are important considerations that must be respected in the development of international standards and assessments made in relation to them.

National government policy affects market outcomes in interaction with private sector behaviour and the success of regulation as a policy instrument depends to a significant extent on encouraging proper behaviour, which requires aligning the incentives of participants with policy objectives. When standards are being set globally, a plurality of perspectives is desirable in encouraging good policy outcomes. In this context, it is increasingly important that there is a strong Asian voice to reflect its particular interests and rebalance the policy development dominance of the US and EU in recent global financial reforms.

Asian financial institutions have grown in scale and importance and Asian centres are now key players in the handling of financial assets. Over the next decade, the combination of deleveraging in the US and Europe and continued financial development in emerging economies will reinforce the trend towards financial regulatory pluralism with a resulting shift of authority in the global financial policy debate to Asia, despite voices having been relatively muted to date.

The level of influence in international forums depends not just on economic weight but also on the state of research and policy analysis at the government, think tank, academia and industry levels.

Australia has performed well in this regard because of its sophisticated financial markets and the effectiveness of its regulatory system during the GFC.

Despite the strengthened coordinating role, the G20 have made clear that the FSB does not represent a path to a form of global financial supervisor. But it does represent recognition that the global network of financial markets needs a corresponding form of network oversight which cannot be achieved by national regulators. This is because a system-wide perspective must play a role in both policy development and supervision even if administrative implementation will continue for the foreseeable future to be conducted at the national and regional level in Europe.

As the authorities have adopted a network approach at the global level it makes sense to think in terms of networks for those seeking to interact with them. The ongoing development of Asian financial markets is important to support future economic growth in the region. Australia has great common interest with Asian countries in ensuring that the global financial regulation reforms are appropriate to the region. It is important that an Asian regional perspective be taken into account in the Financial Stability Board and with standard setters like the Basle Committee.

SECTION 6 – Taxation and the Financial System

KEY POINTS

- The Inquiry should observe that the Government should strike a balance between taxation and regulation policy that attaches priority to the future development of the financial system and it should adopt a co-ordinated, whole of government, approach to policy implementation by its various agencies.
- The Inquiry should articulate a principle to the Tax Reform White Paper process that the taxation treatment of returns from different asset classes should be consistent.
- The Inquiry should recommend the abolition of interest withholding tax for financial institutions that operate in Australia.
- The Inquiry should request that the Government provide a statement of support for the Offshore Banking Unit regime and facilitate bi-partisan support for the regime.

6.1. Introduction and Terms of Reference

The cost of financial intermediation and the effectiveness of the financial system in allocating capital and risk have a direct bearing on the performance of the economy, as discussed in Section 1 of this submission. Taxation is an important component of the operating cost of the financial system, as it affects corporate tax obligations of financial service providers, will help to shape investment allocation decisions and imposes direct costs on financial transactions, through taxes like interest withholding tax and the Goods and Services Tax (GST). Tax is also highly relevant to the international competitiveness of the financial system.

AFMA has long acknowledged the effect that both corporate and personal taxation has on investment decisions and asset allocations and consequently welcomes the inclusion of consideration of taxation matters into the Terms of Reference for the Inquiry, especially to the extent that the tax system affects the efficient allocation of capital both within the financial system and also to Australia from offshore.

AFMA's principal policy position is that the tax system should strive for neutrality across markets and products and that taxation considerations should generally not inform or influence investment decisions. Further, and importantly in the context of the Inquiry, the tax settings need to be viewed through a global lens, such that the international competitiveness of Australia's tax system is of paramount importance in ensuring that the financial system is able to deliver on its stated objectives, particularly in relation to the funding of growth and competition in the banking and wider financial services environments.

It is acknowledged that the Government has committed to undertake a Tax White Paper process subsequent to the conclusion of the Inquiry. This is reflected in the Terms of Reference for the Inquiry, which suggests that the Inquiry will provide observations that could inform the White Paper process. Our comments here are framed consistently with the Terms of Reference.

6.2. Effect of Taxation on Capital Allocation

The current taxation system distorts the allocation of capital by investors to assets of particular classes due to, in part, the taxation treatment of returns arising from assets within those classes. In the context of retail investment of household savings, the final report into "Australia's future tax system" (**the Henry Review**) stated:

> "There is considerable evidence that…tax differences can have large effects on the assets in which a household's savings are invested. The large variations in tax treatment can therefore alter the allocation, ownership and the management of the nation's savings.[35]"

The principal drivers of distortive behaviour are, in AFMA's view, the returns on the assets as opposed to the taxation treatment of financing such investment. Principal distortions arise (for individuals) in respect of the family-home, which is tax free, and capital assets, for which holdings in excess of twelve months qualify the investor for a 50 per cent capital gains tax discount. It is acknowledged, however, that there is a further stratification across asset classes in relation to those that generate assessable income within a particular income year so as to allow for any interest borrowings deployed to acquire such assets to be deductible.

It is particularly important to acknowledge that there are different tax treatments for what may represent economically the same gain. By way of example, any incremental gain in a share held in a company for more than twelve months will benefit from the capital gains tax discount, even where the company did nothing more than hold fixed income securities (such as corporate or government bonds) and accumulate any income received. This can be contrasted with the position where the investor held the same assets directly, where any income arising, either by way of coupon or increase in value, would be assessable income and ineligible for any discount. Similar analogies can be drawn for any increase in the value of capital assets that are reflective of inflation, as opposed to increases in value in real terms.

The Henry Review, in acknowledging this issue, made a recommendation to homogenise the taxation treatment of returns arising from the various asset classes:

> "A move to a broad 40% discount for income from bank deposits, bonds, rental properties, and capital gains and for certain interest expenses would address these problems by providing more consistent tax outcomes. Savings would be allocated more productively, distortions to rental property and other markets would be reduced and household investment and financing choices would better suit their circumstances and risk-preferences. The discount would also provide a means of adjusting for the effect of inflation, which increases the effective rate of tax on savings income.[36]"

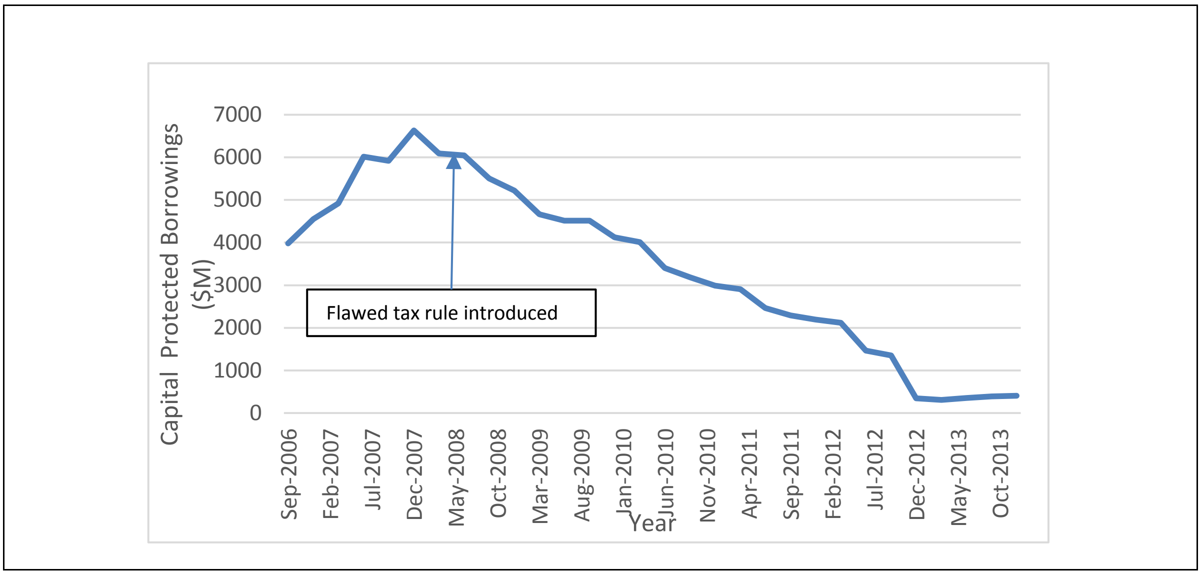
[35] Australia's Future Tax System – Report to the Treasurer," December 2009, p33
[36] Ibid, pp33-34

A recommendation (Recommendation 14) mirroring this statement was included in the final Henry Review report. The response from Government, as articulated in the 2010-2011 Federal Budget, was to implement a 50 per cent discount in income, up to $1,000, arising from bank/credit union deposits, bonds, debentures and annuity products; however this was initially deferred and subsequently abandoned.

In AFMA's view, standardising the taxation treatment in respect of the underlying assets without altering the treatment of the borrowing represents an appropriate approach to remedy distortions. Allowing a deduction for an investor who borrows funds and deploys those funds in income producing assets is a fundamental tenet of Australia's taxation system and should not be disturbed.

We have seen first-hand that the implementation of measures to limit the deductibility of interest incurred to acquire income producing assets can have a significantly deleterious impact on investment through the enactment of the "capital protected borrowing" provisions. Broadly, these provisions cap deductibility on borrowings where there is an element of capital protection to the standard home loan rate (as published by the Reserve Bank of Australia) plus 100 basis points. AFMA accepts the need to take account for the tax law to specifically recognise the capital protection amount as a capital gains tax asset, however, this interest deductibility cap on interest expense is set at an uneconomic level. Table 6.1 exhibits the effect of this measure on the amount of capital protected borrowings held by investors.

TABLE 6.1 – Capital Protected Borrowing



Note: Derived from Reserve Bank statistical tables.

Part of the 90 per cent reduction in the amount of capital protected borrowings is attributable to the effects of the GFC on market confidence and investor sentiment. However, there is no doubt that the decision by the Government to interfere with a fundamental tenet of the tax system by unduly limiting tax deductibility of interest has resulted in a significant move away from capital protected investment, at a time where an element of protection from significant market volatility would have benefitted many investors.

Consequently, AFMA recommends that the Inquiry consider the recommendations from the Henry Review with a view to articulating a principle to the extent that the taxation treatment of returns from particular asset classes should be consistent, when considered on a risk-return basis. That is, distortions that may arise in terms of asset allocation within the financial system as a function of differing taxation treatment should be removed.

6.3. The Competitiveness of Australia's Tax System

The Terms of Reference for the Inquiry makes reference to implications both for how Australia funds its growth and also for domestic competition and international competitiveness. In AFMA's view, the structure of the Australian taxation system directly impacts on these implications.

6.3.1. Funding Future Growth

Australia is, and will continue to be, a net importer of capital while there continues to be a current account deficit[37]. As was noted in the Johnson Report, the persistence of current account deficits, which need to be supplanted by foreign capital, arise primarily due to a higher than average level of private sector investment relative to GDP[38].

For as long as such current account deficits exist, Australia will continue to rely on foreign capital and consequently needs a taxation system that does not unnecessarily hinder the free-flow of funds in and out of Australia. In AFMA's view, the principal impediment to attracting foreign capital is the imposition of interest withholding tax on payments made by financial institutions to offshore lenders.

Currently, in the absence of a specific exemption (generally restricted to the "public offer test" in Section 128F of the 1936 Act, interest paid by an offshore banking unit or a specific exemption in a Double Taxation Treaty), interest paid by a financial institution to an unrelated lender will be taxed at a rate of 10 per cent. For those foreign bank branches that borrow from head office, the rate of withholding tax is reduced to 5 per cent.

Both the Henry Review and the Johnson Report recommended the abolition of interest withholding tax paid by financial institutions. In the words of the Johnson Report, "the application of interest withholding tax to offshore borrowings by Australian based banks is inconsistent with Australia's need, as a capital importing country, to access a diversity of offshore sources of funding." The abolition of interest withholding tax payable by financial institutions would align Australia to many of its principal trading partners and jurisdictions that seek to attract foreign capital. Practically, the imposition of such withholding tax has two consequences; either the reducing the attractiveness of Australia as a destination to invest due to a sub-optimal return on investment or increasing the cost of doing business in Australia in circumstances where lenders demand to be "grossed-up" for the withholding tax. Neither consequence is ideal.

[37] As at the fourth quarter of 2013, Australia's current account deficit was A$10,139 million and has been in deficit at all times since 2008. Source: Australian Bureau of Statistics
[38] Australian Financial Centre Forum, "Australia as a Financial Centre – Building on our Strengths," November 2009, p20

The removal of interest withholding tax is, in AFMA's view, crucial to allow Australia to be able to fund future growth. It is incongruous to the economic reality of being a nation that requires foreign investment that Australia persists with policies that have little effect other than to dissuade such investment[39]. Accordingly, AFMA recommends that the Inquiry provide an observation to the Tax Reform White Paper that recommends the abolition of interest withholding tax on borrowings from financial institutions that operate in Australia.

6.3.2. Domestic Competition

The imposition of interest withholding tax also impinges on domestic banking competition. For those foreign banks that operate in Australia through a branch as opposed to a subsidiary, there are regulatory impediments that preclude such banks from accepting retail deposits, thereby removing access to an important source of funding and increasing the reliance on borrowing from head office. To the extent that retail deposits do not give rise to a withholding tax liability then the imposition of withholding tax on interest paid on the borrowings by the Australian branch to either head office or to an offshore borrower disproportionately affects foreign banks, thereby stymying banking competition and reducing the depth and liquidity of Australia's banking system.

The other major impediment to the promotion of banking competition in relation to Australian branches of foreign banks is the so-called "LIBOR Cap," which operates to cap deductibility in respect of interest paid by an Australian branch to a foreign head office to the applicable LIBOR. Parent funding has become more significant following the market impact of the GFC and the transition process to implement the Basel III capital and liquidity reforms that curtail reliance on the short term NCD market, which has been a traditional funding source for foreign bank branches – see Figure 6.2.

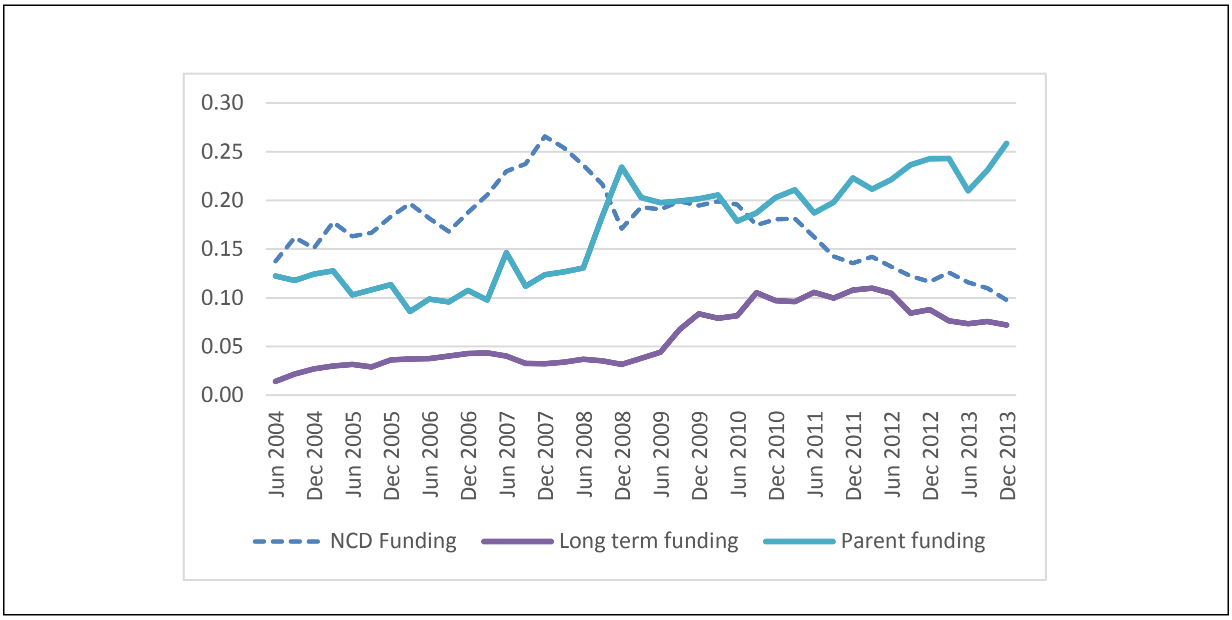
For a myriad of reasons, the existence of the LIBOR Cap significantly under-estimates the true cost of funds for Australian branches of foreign banks[40] and has no real policy basis, especially given moves by the Government to amend Australia's transfer pricing provisions to make them more robust.

The imposition of a penal limit on the tax deductibility of legitimate interest expense would have significant implications for a business but especially so for banks that are by their nature highly leveraged and that operate in low margin markets (for example, see Section 2).

[39] The Government, in 2010, announced that it would accept the recommendations from the Johnson Report and the Henry Review and phase-down interest withholding tax for financial institutions from 2014. However this proposal has been discontinued by the current Government.

[40] For instance, since LIBOR rates only extend out to one year, banks with high credit ratings may still be denied a full deduction for interest expense from head office where this relates to term funding arrangements (eg 3-5 years that may be required for regulatory purposes).

TABLE 6.2 – Foreign Bank Branch Funding (proportion of total liabilities)



Note: Derived from APRA data.

The absurdity of the LIBOR Cap was exacerbated in 2013 when the British Bankers Association ceased to quote AUD LIBOR. This resulted in a situation whereby there was no applicable LIBOR in respect of AUD borrowings and consequently, in AFMA's view, no cap on the deductibility of interest where the Australian branch borrowed in AUD.

The LIBOR Cap is a penal tax that is contrary to the policy objective of promoting competition in the banking market and is harmful to the international competitiveness of the financial system. The Johnson Report recommended the abolition of the LIBOR Cap (Recommendation 3.5) but, to date, this has not been taken up by Government.

6.3.3. International Competitiveness

AFMA continues to support the further development and refinement of Australia's Offshore Banking Unit (OBU) regime. The regime supports the competitiveness of Australia's taxation system and the attraction to and retention by Australia of mobile financial service activities. A number of AFMA's members highlighted the existence of the regime as a core reason as to why they continue to conduct business in Australia and expressed the view that the regime complements the stable political and regulatory regimes when assessing Australia's attractiveness as a place from which to undertake business.

The OBU regime, through taxing profits arising from eligible OB activities at a reduced rate and providing an exemption for interest withholding tax where funds are borrowed in a compliant fashion, places businesses that use the regime to transact with foreign counterparties in a consistent and competitive taxation environment with those that operate in Hong Kong and Singapore.

There have in recent times been a number of issues arising with respect to the administration of the regime and ensuring that the regime remains current in light of the development and innovation of global financial markets. AFMA continues to work with the Government and the ATO to ensure that these issues are resolved and that the OBU regime operates in accordance with its policy objectives. In this regard, there were a number of recommendations from the Johnson Report arising with respect to the OBU regime that continue to be refined and implemented.

AFMA is of the view that the OBU regime is not utilised as significantly as it could be and believes that one of the reasons for the less than optimal take-up of the regime is a concern about its ongoing viability. Compliance with the significant systems and record-keeping requirements that are fundamental to the integrity of the regime require substantial resources and AFMA believes that a number of financial market participants have not historically seen the necessary commitment from Government that provides sufficient confidence to justify the incurring of the expenditure. The first of the OBU related recommendations in the Johnson Report was that the Government:

> "include a statement of support for, and commitment to, the OBU regime. Such a statement could also refer to arrangements to ensure the ongoing competiveness of OBUs."

AFMA is not aware that any such statement of support has been provided. We recommend that the Inquiry again request that such a statement be made by Government.

6.4. Implementation of Regulatory Reforms Holistically

AFMA is concerned regarding the manner in which, in recent times and particularly post-GFC, governments have adopted a patchwork approach to the taxation implications of regulatory changes. In particular, we are concerned that governments have sought to align taxation outcomes to regulatory reforms only where it gives rise to a revenue accretive outcome, while failing to provide relief for changes to regulatory reforms which give rise to unintended and erosive consequences for taxpayers.

For example, in the 2013-14 Federal Budget, the Government announced an increase to the thin capitalisation safe harbours for ADIs from 4 per cent of risk weighted assets to 6 per cent of risk weighted assets. Essentially this requires ADIs to hold more equity and hence reduces the deductible interest that they can claim. This change aligned to the implementation of the recommendations of the Basel Committee in Basel III and, from a local perspective, the amendments to the Prudential Standard on Liquidity (APS210). AFMA has no objections, in principle, to the aligning of the taxation safe harbour to the regulatory requirements.

This example may be contrasted against the G20 move towards central clearing of standardised OTC derivatives. In order to adhere to the implementation of the G20 requirements from an Australian perspective, standardised OTC derivatives entered into by Australian parties need to be cleared through an appropriately structured and regulated central counterparty (CCP), which effectively takes on the transaction as principal against both parties. To the extent that any interest is paid on collateral posted under the OTC derivative, such interest is paid to the CCP and, where the CCP is situated offshore, results in a *prima facie* interest withholding tax obligation. Acknowledging the unintended nature of this consequence and the fact it only arose due to the implementation of the

G20 commitments, AFMA, the Australian Bankers' Association and the Financial Services Council requested that the Government provide a legislated interest withholding tax exemption for interest flows related to trades cleared in accordance with rules set by CCPs. No relief has been granted thus far.

These examples serve to illustrate that, in AFMA's view taxation policy is not aligned with other government policies and regulatory reforms, particularly where such alignment would not be accretive to the budget bottom-line. There needs to be a co-ordinated approach and governments should not use regulatory changes as an opportunity for windfall gains due to unintended tax outcomes. We urge the Inquiry to make this observation, as a whole of government policy approach to financial services is necessary to achieve its real economy objectives.

SECTION 7 – Wholesale Banking and Financial Markets

KEY POINTS

- The Government should work in conjunction with the industry to develop a strategic plan to develop the financial services sector in Australia in a way that balances innovation, competition, regulation/consumer protection, and revenue raising.
- Implementation of the approach suggested in Sections 4 to 6 in relation to the government processes for policy, financial regulation and taxation would set the right framework to achieve this.
- The Government should have in place long term, integrated policy settings that will give business certainty for planning and facilitate the further development of the financial system.

7.1. Policy and Regulation to Support Future Development

The future development of the financial system, and wholesale banking and financial markets in particular, will be substantially driven by the response of industry participants to the competitive pressures they face in the market place. Because the financial system is one of the most highly regulated sectors of the economy, future policies adopted by the Government and the operation of the regulatory and tax regimes will necessarily also be significant factors in shaping the future design and operation of the financial system.

The great practical challenge for government is to intervene in markets only in situations where this is warranted by a market failure and this intervention will improve to outcome. Overcoming this challenge requires a disciplined process that enables an objective and clear sighted review and assessment of policy and regulatory proposals.

In this regard, implementation of the approach suggested in Sections 4 to 6 above in relation to the government processes for changing financial regulation and taxation would set the right general policy framework to support development of the wholesale banking and financial markets. Specific policy objectives may need attention as particular proposals are designed; for instance:

- Facilitating competition within the financial system;
- Promoting development of the financial system, including integration with overseas financial markets;
- Tax rules and an approach to tax administration that do not frustrate business development.

In conducting this work, it is important that the principle of regulatory and policy neutrality between different products and different providers is applied diligently.

This approach by government would enable the development and application of policy that provides the level of stability, consistency and certainty required for market participants to make decisions about the long term commitment of capital and other resources to their business in Australia. This, then, would provide a sound basis for the wholesale banking and financial markets to be further developed by industry participants in a manner that best serves the real economy.

In this context, we note that the rapid evolution of financial market infrastructure around the globe driven by a huge volume of financial regulation reform in many jurisdictions and commercial competition driven by the reordering of global economic activity mean that careful attention needs to be paid to the broad policy framework for financial market infrastructure within its overall economic and competition context. AFMA has consistently supported the need for a holistic policy review of financial market infrastructure regulation, particularly with regard to clearing and settlement infrastructure that integrates market integrity goals with consideration of competition issues and market efficiency. This is in order to produce a strategic policy framework that provides clearly articulated principles to guide law reform and government decisions affecting ownership and control of financial market infrastructure, in a way that provides long term consistency and predictability for the market.

Competition in financial markets should work to the benefit of market participants and investors by delivering lower prices, innovation and better market access. Therefore, AFMA supports the provision of an open, competitive environment for market infrastructure where it is of benefit to market users, while giving the regulators the tools necessary to manage systemic risk.

Therefore, having regard to the above, the Government should work in conjunction with the industry to adopt a strategic approach to the ongoing viability of the broader financial services sector in Australia that balances the interests of innovation, competition, regulation/consumer protection, and revenue raising.

The following sections take a look into specific aspects of the wholesale banking and financial markets that require specific consideration and concern matters beyond the broad framework considered here including the corporate bond market, retail markets and professionalism in the industry.

We also believe that the Government needs to make a commitment to maintain the business and tax conditions that are conducive to the conduct of financial services business in Australia and keep Australia internationally competitive, to the great extent possible. This is discussed further in Section 11 below.

SECTION 8 – The Corporate Bond Market

KEY POINTS

- A well-developed corporate bond market has a significant number of benefits for the funding and financial stability of the economy and for its various participants. For instance, it provides an efficient, flexible and safe mechanism to connect investors and borrowers, provides business with an additional source of funding, offers savers diversification benefits and may free up bank balance sheets, while enhancing competition in the financial system.
- However, there are a number of significant impediments to development of the market:
    - The costs for issuers and the impact of local regulations for corporate borrowers have restricted their capacity to issue into the market;
    - An equity bias amongst wholesale investors, and a focus on benchmark performance;
    - Taxation outcomes relative to other asset classes;
    - Lack of access for retail investors for most corporate issues; and
    - Lack of education of retail investors.
- Initiatives that might assist in the development of the corporate bond market and should be considered include ensuring that:
    - It is no more onerous for corporate borrowers to raise funds via the Australian corporate bond markets, both wholesale and retail, than other sources, including the Australian equity market, bank financing and offshore debt markets;
    - Investors, particularly retail, have adequate access and greater choice; and
    - Investors, both wholesale and retail, have the necessary skills and knowledge required to recognise the importance and benefits of corporate bonds in their portfolio, particularly in the context of an aging population.

8.1. Introduction – The Need for a Well Developed Corporate Bond Market

The funding of the economy in the future is a central theme of the Inquiry and the corporate bond market is widely held to have a prominent role in this regard. A well-developed corporate bond market has a significant number of benefits for the funding and financial stability of the economy as a whole and for its various participants, including government, issuers, investors (both wholesale and retail), and bank intermediaries. Section 2 of this submission provided some high level insights into the current state of the Australian corporate bond market and, clearly, there is work to be done for the market to reach its potential.

Much has been written about the benefits of an efficient corporate bond market, and the main benefits are described below. This provides a useful context within which measures to assist the future development of the market can be considered.

Financial Stability

Corporate bond markets provide an efficient, flexible and safe mechanism to connect investors with borrowers that require funding. They allocate savings pools to productive investments, provide finance to companies needing to expand, and provide facilities for the competitive transfer and pricing of capital resources. In the context of the Australian economy, they provide the ever growing pool of savings resources, most notably our superannuation funds, with a means to invest in and finance our ever growing corporate and government infrastructure funding needs.

An efficient corporate bond market can promote financial stability in the economy, by creating a resilient domestic market that reduces exposure to offshore events. This has become considerably more important in the wake of the GFC. A functioning domestic corporate bond market can play a key role as a stabilising mechanism in times of global market crises. In times of economic stress, the corporate bond markets also reduce the reliance on the banking sector for financing needs.

In this context, it is important to note the inter-relationship and dependence between the wholesale and retail markets for corporate bonds. A deep, liquid and diverse institutional market can assist the development of a retail corporate bond market by providing price transparency and liquidity. This helps to improve retail investor confidence in the market. Likewise, the availability of retail-sourced funds provides an alternative avenue for borrowing funds, and complements price discovery for wholesale markets (as per the equity market).

Government

A well-developed corporate bond market can help achieve various government policy objectives, not the least being the alleviation of funding pressures associated with an aging population. Australia's superannuation system plays a key role in this regard. To the extent that corporate bonds provide a means of assisting in creating wealth for superannuation funds, this further reduces the need for the Government to provide an age pension as an alternative. In particular, by providing a less volatile, lower risk product as part of a retiree's asset mix, corporate bonds can assist in reducing the need for public pensions.

In addition, a corporate bond market can serve as an alternative means of funding projects that would traditionally have been on government balance sheets, such as student loans, or more importantly infrastructure projects via such mechanisms as private-public-partnerships (PPPs). In doing so, the corporate bond markets can ease pressure on public funding, and help limit government indebtedness.

Corporate Borrowers

For corporate borrowers, the corporate bond markets can provide a secure, stable, flexible and reliable source of term-finance for both financial and non-financial corporates alike. A well-developed market provides borrowers with confidence of being able to tap funds as and when required.

The corporate bond market provides diversity for borrowers as it can offer a competitive alternative to bank financing and equity financing, reducing the reliance on banks. The corporate bond market can provide enhanced access to long-term funding in the local market where Australian corporates can better leverage strong brand recognition. For smaller borrowers who may not be able to access this market, a developed corporate bond market for banks allows the banks to provide more competitive loan finance, and then be able to offset these loans via issuing corporate bonds.

The existence of well-developed local corporate bond markets can help corporates manage foreign exchange rate risk, as corporates can borrow in local currency to fund local operations. In addition, to the extent that local companies have offshore operations, the existence of strong offshore bond markets also helps reduce this risk. The large number of product types (fixed, floating, inflation-linked) and terms allows for better management of interest rate risks, avoiding cash flow and maturity mismatches.

Well-functioning corporate bond markets also facilitate the efficient use of working capital, helping to avoid the need for companies to hoard cash due to fears of future funding availability from banks. In addition, a competitive corporate bond market has the potential to provide a lower cost form of financing to traditional bank lending.

Corporate bond funding encourages higher standards of corporate disclosure and transparency, and promotes consistent high-quality international corporate governance standards. The corporate bond market is more transparent and less volatile than alternative funding sources such as hedge funds.

Investors – Wholesale and Retail

For investors, both wholesale and retail, it is arguable that there has never been a more appropriate time to have a well-developed corporate bond market. As our demographics continue to show a shift towards an aging population, there has never been more of a need for less volatile investment returns to complement investment portfolios. Post-GFC, investors are more interested in securities which provide less volatile returns, safer income streams, and more diversified investment portfolios. By weighting more heavily an investment portfolio to fixed income securities, an investor reduces the risk of major losses of value which cannot be regained prior to retirement. This, as noted above, reduces the risk that retirees need to rely on government pension assistance.

In the retail sector, the increased volumes and growth of self-managed super funds (SMSFs) represents a compelling need for the ability of retail investors to access a market which is largely stable and secure, and diversifies investments away from equities, property and cash. For retirees, it is more important to source products which can more provide stable and secure returns than equities. This is evidenced by the growing number of debt-like “hybrid” instruments on issue in recent years.

In the wholesale sector, increased growth in superannuation funds, now one of the major sources of long-term capital in Australia, creates an obvious requirement for funds to have fixed income alternatives with long-term security and reliable income streams.

Corporate bond markets provide a greater range of investment opportunities to participate in a wider range of fixed income alternatives to traditional government debt and the equity market. By adding this diversity, corporate bonds can increase the alternatives available for portfolios on a risk/return basis. Whilst bank issued debt is relatively plentiful for wholesale investors, a mature corporate bond market can provide additional credit diversification as well. In addition, the provision of additional alternatives can assist in neutralising the current investment bias to equity allocation that exists in Australia.

The existence of a diversified local corporate bond market can allow local funds to achieve their required diversification without having to invest offshore, hence minimising foreign exchange risk. An increase in the types and terms available also helps funds the required cash flow profile, reducing interest rate and maturity mismatch risk. The transferable nature of corporate bonds also allows for investors to change their investment profile as and when they need, realising investments when necessary. Finally, a well-diversified, efficient corporate bond market can enhance the wealth of all Australians.

Intermediaries

The Basel III international regulatory capital framework requires banks to focus on their large exposures and exposures to certain sectors. The effect of the Basel III rules is to require banks to hold higher levels of capital for such exposures. Development of corporate bond markets provides increased opportunities for banks to reduce their exposures and play more of an intermediary role, earning fees in the process for arranging and market making.

In addition, to the extent that larger corporations can take further advantage of the corporate bond market rather than traditional bank financing, this further frees up the banks' balance sheets to support more small and medium sized enterprises.

8.2. Issues Affecting the Development of the Corporate Bond Market in Australia

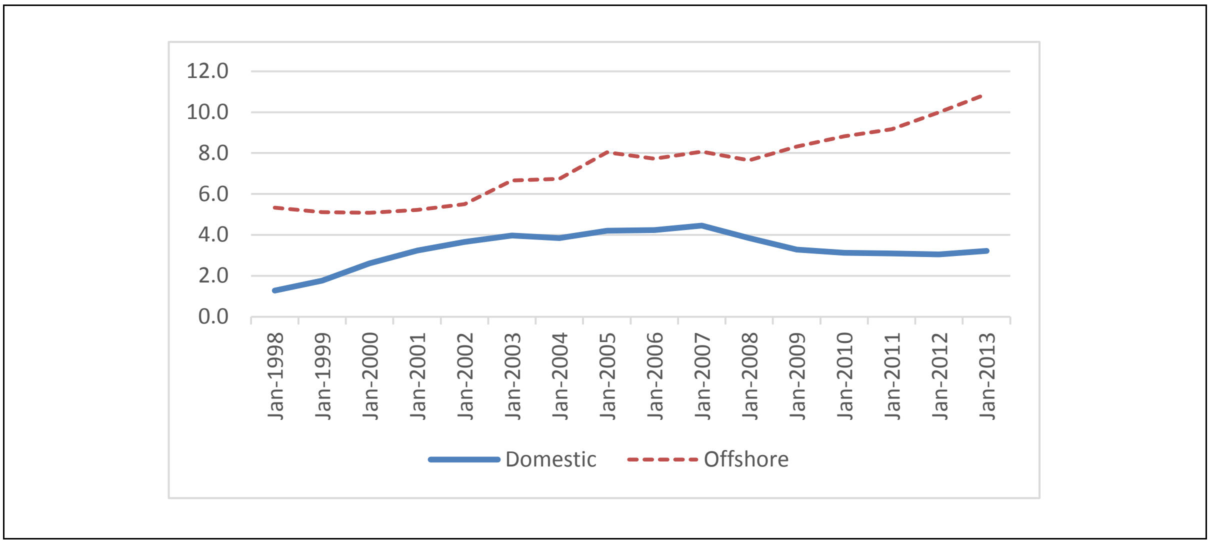
Despite the numerous benefits that a well-developed corporate bond market can provide to the financial stability of the Australian economy and to its participants, it is important to understand the current impediments to this development. It is worthwhile to first understand the perspectives of each of the main participants in the market, and then examine recent government initiatives to address these issues.

The Borrower's Perspective

As noted above, an efficient corporate bond market can provide a stable, diversified source of funding as an alternative to other sources of debt, and preferably at a lower cost. However, from an issuer's perspective, this has not been the case.

It is evident that Australian corporates and banks issue more bonds overseas than they do in Australia. Data from the Reserve Bank of Australia (RBA) shows that non-financial corporates at end-December 2013 had issued $181 billion offshore, over three times as much as the $52 billion issued in Australia. Banks and other financial institutions had issued $351 billion offshore, nearly twice as much as the $157 billion issued in Australia. Looking back at the market's development since the Wallis Financial System Inquiry, it is evident that the market has made only modest progress in real terms, while the offshore market has blossomed – see Figure 8.1.

FIGURE 8.1 - Australian Corporate Bond Issues (% of GDP)



Note – Derived from RBA for non-financial corporations bonds on issue and ABS data.

The depth, available tenor and liquidity of offshore markets, particularly US markets, have provided an attractive source of financing for Australian corporates, despite the potential additional documentation costs, arranging fees and foreign exchange management issues. It appears that it is easier for Australian corporates to raise large amounts of capital at a competitive price in offshore markets. In this regard, given the size of the Australian investor base, and their preferences (refer below), it is difficult to compete.

Note that this may be on occasion a moving target, as the costs of hedging offshore issuance back into Australian dollar debt tends to rise and fall, making the Australian market more attractive on rare occasions, provided the size required is available.

In the retail markets in Australia, the costs of issuing bonds, including ongoing costs have made issuance fairly prohibitive. These are often due to onerous costs related to prospectus regulations, as well as investment bank fees and financial advisor commissions. There have also been concerns about directors' liability with respect to retail issuance. While there has been an attempt to address some of these issues, there is still a way to go.

From a tax perspective, there remains an asymmetry between the treatment of debt and equity financing from both an issuer and an investor perspective. For issuers, debt financing may give rise to deductible returns and consequently reduce the cost of issuance. However, such returns will not allow for franking credits to flow to investors, unlike returns on equity financing instruments, such as shares, which are also eligible for the capital gains tax discount when held by individuals/complying superannuation entities. These discrepancies may hinder the development of a corporate bond market relative to other jurisdictions (such as those without a dividend imputation regime or those which treat returns on assets consistently from a tax perspective).

The Wholesale Investor's Perspective

Australian pension funds have a heavy bias towards equity investment by international standards. Superannuation fund managers and trustees have a responsibility to act in the best interests of investors in taking into account the full range of investment options and the weighting given to them in a diversified portfolio.

A recent OECD report showed that Australian superannuation funds have an average asset allocation to equities of about 55 per cent and an allocation to fixed interest of about 10 per cent. This is quite imbalanced relative to other major global markets. It is arguable that given the increase in age of the Australian population, there is perennial underweighting in the fixed income asset class which is not conducive to the development of the corporate bond market. This is something that the Australian investment industry could look at addressing.

In addition, the nature of funds management within Australia is that fixed interest fund managers tend to invest according to certain benchmarks to track performance. These fixed income benchmarks are determined by what is actually issued by borrowers, rather than the potential from diverse borrowers' requirements, which includes direct bank and offshore financing. The benchmarks also have limitations on issue size, credit rating and security type (fixed rate). The close investment tracking of benchmarks that consist of the largest borrowers (also mixed with government debt) make it less conducive to invest in what would be new types of issuers. In addition, fixed income mandates traditionally have strict limits with respect to credit quality, further diminishing the capacity of the corporate bond market to develop.

Of course, like corporates, the investment community will only be interested in corporate bonds if they provide an attractive return relative to alternatives. Given the number of debt alternatives available in offshore capital markets, and given the costs to issuers described above, it is not clear that local corporate bonds can offer a competitive rate.

In addition, the current taxation settings offer no incentive for wholesale investors to invest in corporate bonds vis-à-vis equities. As noted in Section 6, accretions in the value of equities are taxed advantageously in the hands of superannuation entities through the capital gains tax discount, where by definition any yield on bonds is paid out as a fully assessable coupon. In addition, superannuation entities are able to obtain a refund of any excess franking credits attached to dividends.

The Retail Investor's Perspective

From a retail investor perspective, Australians traditionally have seen their investment options as cash, shares and property (whether the assets are held directly or through superannuation). Corporate bonds or other fixed income assets have not loomed large in their investment portfolios.

In practice, it is likely to be self-managed superannuation funds and high net worth individuals who have the capacity to invest significantly in bonds. In time, and with appropriate incentives and structures in place, ordinary investors may develop an appetite for products beyond cash, shares and property.

Part of the reason for the traditionally low retail investment in corporate bonds may be an issue with financial education of investors (and possibly their financial advisors). With respect to fixed income in general, there may be a gap in knowledge within the retail base about the product in general, or at least its purpose and place in a balanced portfolio. With respect to particular corporate bonds, it is arguable that few retail investors have the credit assessment skills to determine value in the market. At this time, most of the major credit rating agencies providing services in Australia have elected not to hold an Australian financial services license that enables them to provide financial services to retail investors. It is understood this is due, at least in part, to the more onerous obligations that apply to a license of this type, including the obligation to be a member of an external dispute resolution scheme.

Another potential reason for the lack of participation to date could be lack of access to the market. Australian corporate bonds are primarily issued in the wholesale market, which, unlike the equity market, is not accessible to most retail investors. Minimum investment parcel sizes are usually $500,000, which is difficult for even the largest retail investor to access. Recent innovations by brokers allowing clients to invest in smaller parcel sizes via custodial services is helping to change the landscape albeit slowly. It is arguable from a retail perspective that transparency in the market is low.

In addition, this market is limited by the Corporations Act such that wholesale corporate bonds are only available for wholesale and sophisticated investors (which is a definition restricted to very high income producing or high net worth individuals).

Interest income on bonds is taxed at a higher marginal tax rate than franked dividends and hence the attractiveness of this asset class to retail investors compared to other investments is open to question. This is illustrated by the high yields offered by hybrid securities which have been successful due to the fact that the high yield includes franking credits due to the equity characterisation of such instruments for tax purposes.

As with wholesale investors, retail investors will only invest in corporate bonds if they are attractive relative to equivalent assets. In this regard, the Financial Claims Scheme provides government guarantees for cash deposits up to $250,000 at any individual bank. In an environment with a relatively flat yield curve and competitive deposit rates being offered by banks, yields on corporate bonds have to be sufficiently attractive to retail investors to be invested in.

The Intermediary's Perspective

The Basel III liquidity reforms would suggest that intermediaries in principle would be interested in developing the corporate bond market in Australia, as the costs of maintaining bank lending as the economy grows would be high, whilst the fees that new issues and market making in the corporate bond market may provide could be attractive. However, some have argued that larger fees and profits from providing additional services such as currency swaps may create an incentive toward offshore based corporate markets, given the ease of access and sizes of issues.

In terms of liquidity provision, the Basel III liquidity reforms also restrict banks' capacity to assist with providing liquidity. Trading volumes and dealer inventory has reduced since 2008 as a response to the Global Financial Crisis and the Basel III reforms. In addition, the "buy and hold" nature of the product and issuers' opportunistic approaches to adding to issues is also an impediment to creating further liquidity.

Recent Regulatory Developments

Both sides of politics have expressed support for the continued development of the corporate bond market in Australia, and recent government initiatives to offset some of the impediments described above include the following:

- Recent relaxation of prospectus laws for "vanilla" bond issues – transaction specific and two-part prospectus and the removal of potential criminal liability for directors. This has helped reduce issuance costs.
- The introduction of bank "covered bonds" in Australia. This allows a new kind of investment previously not available to investors, wholesale or retail.
- Listing of beneficial interests in Australian Government Bonds on the ASX. This helps link the wholesale and retail markets and provide supply to retail investors.
- Commitment by government to further establish and lengthen the Australian Government Bond curve. The establishment of a government bond curve assists in providing a pricing benchmark for corporate issues.

Whilst all these initiatives are beneficial in helping develop the corporate bond market, it is arguable if they have gone far enough, and whether more could be done. Suggestions for further initiatives will be discussed in the next section.

8.3. Suggested Initiatives to Support the Development of the Corporate Bond Market

Given the benefits of a well-developed corporate bond market for the overall financial system as well as its participants, it is important for the industry as a whole to continue to work towards this ultimate goal. Given the impediments described above, there is no one "silver bullet" solution to this issue.

There is solid potential for development of the corporate bond market in Australia in both the wholesale and retail sectors (albeit the wholesale sector may offer better prospects in the short term), but this will take time. It will depend on a number of elements including government policy and legislation, taxation, distribution, and also the investment mentality or investment culture of

Australians. It will also depend on investment objectives and on risk, cost and return relativities in the marketplace.

It is important for all interested parties – policy makers, regulators, issuers, investors, intermediaries and other market participants, to work together in a consultative and collaborative manner towards solutions that achieve a number of inter-related objectives:

- To ensure that it is no more onerous for corporate borrowers to raise funds via the Australian corporate bond markets, both wholesale and retail, than other sources, including the Australian equity market, bank financing and offshore debt markets.
- To ensure that investors, particularly retail, have adequate access and greater choice in corporate bond markets.
- To ensure that investors, both wholesale and retail, have the necessary skills and knowledge required to recognise the importance and benefits of corporate bonds in their portfolio, particularly in the context of an aging population.

With these objectives in mind, we can begin to determine some potential initiatives to achieve these goals. It is important that industry continues to find ways to collectively achieve these objectives.

Removing Constraints for Issuers

The message from corporate borrowers is that the current regulatory environment imposes onerous restrictions on their capacity to raise debt in the corporate bond markets (particularly in the retail market). Regulations currently create onerous constraints and costs on borrowers which allow alternative markets, such as equity and offshore debt, to become more attractive. Whilst it will be difficult for Australian debt markets to provide sufficient depth and liquidity to match what is available offshore, there are a number of local constraints that can be examined and adjusted to reduce the burden.

Given the lower risk nature of corporate bonds versus equity products, it appears incongruous that the current regulatory regime appears to make it harder to raise corporate debt than equity finance.

Whilst a number of regulatory initiatives have been undertaken in recent years to help alleviate burden and cost, it is arguable that a lot more could be achieved in the following areas:

- Prospectus requirements – With respect to prospectus requirements for debt, the current requirements should be replaced with much simpler documentation, such as via term sheets, similar to what is required in the wholesale markets. Similarity in the style of documentation required will assist in the ease and efficiency of issuance to the market, and significantly reduce costs.
- Directors’ responsibilities – the reform of directors’ liability for prospectus and other documentation issued for retail corporate bonds should be reviewed.
- Disclosure requirements – The continuous disclosure regime within the ASX should be utilised with respect to retail corporate bonds.

- As per our recommendations in Section 6, the taxation treatment of returns from different asset classes could be made consistent, when considered on a risk-return basis.

Investor protection remains an important issue with such initiatives, and must be taken into account.

Improving Access for Investors

A telling statistic is that approximately 95 per cent of all corporate bonds are issued in wholesale markets only, and almost all retail investors are unable to invest in these securities due to regulation. Again it appears incongruous that a product that provides a lower risk/return trade-off for investors is largely inaccessible to them, whereas a higher risk product such as equities is significantly more easily accessible. In particular, the Corporations Act definition of "wholesale" investor effectively disallows the vast majority of retail investors from participating in the wholesale bond market.

Consequently, initiatives to bring the wholesale and retail markets closer together can improve access to all investors to the bulk of debt securities on offer and be beneficial in creating a more efficient market. Whilst there have been recent industry efforts to increase bond accessibility and reduce minimum parcel sizes, and the creation of Chess Depositary Interests (CDIs) on the ASX for Australian Government Bonds have been beneficial, more initiatives can be pursued to increase access for investors.

Liquidity is an important issue here, as it is important for both wholesale and retail investors to be able to change their investment mix. Given the "buy and hold" nature of the product, and a decreased risk appetite from banks post-GFC, this is a difficult problem to solve, and an area for all industry participants to address.

Suggestions in this regard include the following:

- The CDI concept should be extended to corporate bonds, such that wholesale corporate bonds can be traded by both the wholesale and retail market.
- Industry and government initiatives to support the liquidity of the corporate bond market and increase the range of issuers and product types with different credit-worthiness should be encouraged. For example, the Government has a number of enterprises which could issue corporate bonds and therefore contribute to the market, particularly the retail market, such as Australia Post and Airservices Australia. The Government could also sponsor special-purposes entities to issue corporate bonds for infrastructure projects, assisting to fund the significant infrastructure investment that Australia needs to make incoming years.

Education

Of course, all the above initiatives will amount to little if investors are not interested in the product. With respect to institutional investors, the relatively high asset allocation weighting in equities and the consequent relatively low weighting in fixed income is a perplexing issue. Whilst education appears not to be the issue here, it is puzzling from an outsider's perspective why this equity-focused culture exists.

As noted earlier, given the retail sector's current allocation to fixed income, it is easier to suggest that education is more of an issue here. Perhaps retail investors or their advisors require further education as to the nature and characteristics of fixed income, and the benefits of corporate bonds within a well-diversified portfolio. Also, perhaps they do not have the necessary skills (or even information) to determine an appropriate credit risk premium for corporate debt. It may well be that simplification of documentation, as suggested above, may help inform investors more adequately.

Suggestions in this regard include the following:

- There should be continued discussions within industry and government that question the reason for the high weightings in equities amongst institutional funds, and whether or not this reason is justifiable in the context of investing suitably for an aging population, particularly in a volatile post-GFC environment. The government could take the lead here, for example, by recommending or publishing appropriate asset allocation weightings for various age-based scenarios.
- There should also be continued industry and government efforts to educate retail investors and their advisors as to the pricing, characteristics and benefits of corporate bonds to ensure they are better educated and reliably informed.
- A review of the licensing requirements that disincentivise credit ratings agencies from participating in the retail bond market could be undertaken. Credit ratings for retail bonds would greatly assist retail investors' capacity to understand the relative creditworthiness of various bond issues and apply an appropriate credit risk premium.

Industry Collaboration

The development of the corporate bond market is an industry-wide goal, and all participants – policy makers, regulators, market operators, intermediaries and end users - must collectively work together to achieve these objectives.

As these objectives are highly inter-related, collective industry efforts are necessary to achieve them. We suggest that a Corporate Bond Development Council is created, consisting of representatives of all the types of participants and affected parties. To a significant extent, development of the corporate bond market is in the hands of the industry and the question is how to most effectively harness the complementary commercial interests that exist between issuers, intermediaries, investment managers and retail investors. The purpose would be to identify, analyse and progress initiatives to develop the corporate bond market in a collaborative manner, having regard to the interests of the stakeholders and the overriding objectives of the market as a whole. This could either be an industry or government-led initiative.

SECTION 9 – Retail Financial Markets

KEY POINTS

- The structure of the retail investment industry is changing as a result of the GFC and its impact on market conditions globally, regulatory reforms in response to the GFC and other domestic events, and because of the changing demographic of retail investors including their growing inclination to think about information and advice about investments through technological innovation rather than more traditional advice models.
- At the same time, the cost of compliance and providing financial services is continuing to increase, and Australia is moving towards being at a competitive disadvantage compared to other centres that are able to provide services to Australian investors.
- In terms of the regulation of retail financial services, there are several areas where AFMA recommends that a review should occur. These include:
    - the ongoing usefulness of the disclosure regime in its current form;
    - the effectiveness of the licensing regime as a mechanism to ensure high standards of conduct by persons who provide financial services;
    - the current predilection of regulators to try to impose additional obligations on industry participants above and beyond statutory obligations;
    - the way in which regulatory resources are allocated to supervision of risk areas; and
    - the completion of the review of the distinction between retail and wholesale investors in the legislation commenced by the previous Government in 2012.

9.1. Background

Retail Investor Participation

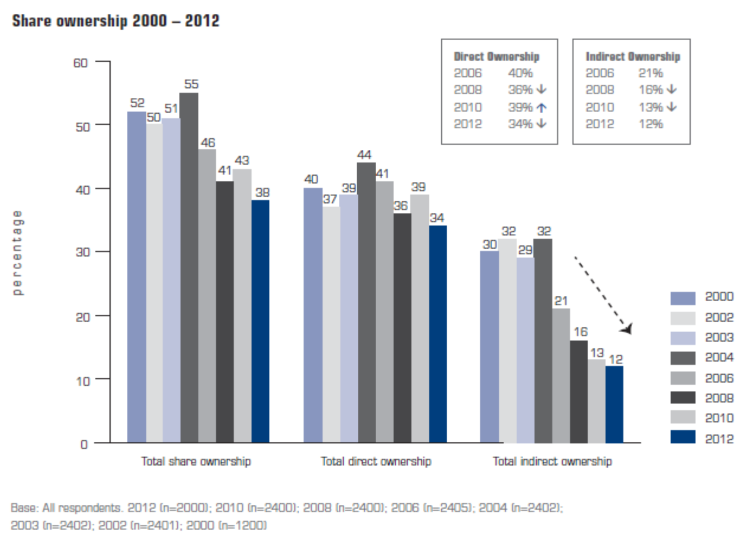
There is a perception in Australia that there is a high level of retail participation in financial markets. While that may be the case in certain asset classes, retail participation is more limited across a broader range of asset classes.

The cash equities market has traditionally been an attractive area to retail investors, partly as a result of a number of very significant privatisations of government-owned business (eg Qantas and Telstra), demutualisations (eg AMP and NRMA) and public floats of “name” companies (eg David Jones) that occurred in the 1990s and early 2000s.

The Australian Share Ownership Study published by ASX is a key source of information about ownership of listed equities. The 2013 study states that in late 2012, 6.68 million people, or 38 per cent of the adult Australian population participated in the Australian share market either directly (via shares or other listed investments) or indirectly (via unlisted managed funds). The level of direct participation in the Australian share market was 34 per cent, or 5.98 million people.[41]

The study also notes that share ownership has decreased since 2010 – overall share ownership (direct plus indirect) decreased from 43 per cent in 2010 to 38 per cent in 2012 (see Figure 9.1). The proportion of the population holding shares directly fell from 39 per cent in 2010 to 34 per cent in 2012. The proportion of the population with only direct share ownership decreased from 30 per cent in 2010 to 26 per cent in 2012, while those holding shares only indirectly remained stable at four per cent.[42]

FIGURE 9.1



Source: Australian Share Ownership Study 2013, ASX

Finally the study also notes that the average value of trades and the average value invested have declined since 2010. The average value of trades reported by investors in 2012 fell 11 per cent to $12,730 (down from $14,350 in 2010) and the average value invested declined by over $24,000 (from $163,885 in 2010, to $139,380 in 2012).

Superannuation is the other asset class with a high level of Australian retail investor participation, driven largely by the mandatory contribution arrangements and the preferential tax treatment that applies to contributions in some circumstances. Within this asset class, self-managed superannuation funds (SMSFs) are becoming increasingly attractive to a growing percentage of retail investors, albeit that retail funds and public sector funds still manage the bulk of retail investor superannuation.

[41] 2013 Australian Share Ownership Study, ASX Limited, page 3
[42] Ibid, page 3

A 2011 report by KPMG on superannuation trends and implications says that during the period from June 2000 to June 2011 the 'small funds segment' which is comprised predominantly of SMSFs, grew by 461 per cent.[43] As at June 2011, approximately 33 per cent of assets as a percentage of total superannuation assets were held in small funds, up from approximately 18 per cent in June 2000. Industry, corporate, public sector and retail funds held the balance of assets.[44]

Interestingly, in the context of retail investors, the KPMG report shows that the growth areas are in small funds and industry funds. Retail funds have remained relatively steady at around 30 per cent of assets as a percentage of total superannuation assets over the period June 2000 to June 2011. Assets held by corporate and public sector funds have declined to around five and 16 per cent, respectively, of assets as a percentage of total assets over the period.[45]

However, retail funds remain the dominant fund type as a percentage of total members, with just over 50 per cent of all members. Industry funds have approximately 35 per cent of total members, whereas the small fund segment represents approximately two per cent of total members.[46] This latter figure has been largely unchanged since June 2000, which suggests that the same number of SMSF members are investing more assets in their SMSF funds.

The third asset class that is traditionally attractive to retail investors is bank deposits, including term deposits. The GFC saw a flight of assets into these "safe" products, particularly in light of the government guarantee over bank deposits.

Beyond these asset classes, however, retail participation is much more limited.

Anecdotal evidence indicates that only one per cent of corporate bonds are held by retail investors. This contrasts with other markets like the United States and the United Kingdom where retail participation is closer to 40 per cent.

Similarly, anecdotal evidence suggests that retail investors represent no more than five per cent of clients who trade in exchange-traded derivative products on the ASX24 market.

A recent report by ASIC about complex financial products[47] shows that in 2012:

- 22,500 people were invested in agribusiness managed investment schemes;
- 18,000 people were investors in hedge funds;
- 75,000 people were investors in hybrid securities (products with a combination of 'equity-like' and 'debt-like' characteristics);
- 41,000 people were investors in leveraged derivative products including contracts for difference (CFDs) and margin FX contracts;
- 32,000 people were investors in capital-protected structured products; and
- 12,500 people were investors in non-vanilla warrants.

[43] Superannuation Trends and Implications November 2011, KPMG and the Australian Centre for Financial Studies, page 2
[44] Ibid, page 8
[45] Ibid, page 8
[46] Ibid, page 9
[47] ASIC Report 384 – Regulating complex products, January 2014, pages 13-15

It is probable there is a degree of cross-over of investors in the above products – that is, an investor will own more than one category of the products listed in the bullet points.

In line with the decline in direct share ownership, the aggregate level of margin lending has fallen sharply post GFC as risk appetite has dissipated, particularly amongst retail investors. The below table, sourced from the Reserve Bank's quarterly survey of margin lending, shows that aggregate credit limits peaked in December 2007, but have steadily fallen since that time and are now at pre-June 2006 levels.

TABLE 9.1 – Margin Lending

	Total Margin Lending $m	of which is Protected financing:	Aggregate credit limit	Value of underlying security	Number of clients accounts	Average number of margin calls per day per 1000 clients
As at		**$m**	**$m**	**$m**	**'000**	
Jun-2004	13927	1279	28483	28921	132	1.23
Dec-2004	15524	1403	33928	35031	134	1.10
Jun-2005	18534	1907	39309	40691	144	0.55
Dec-2005	20827	2176	49946	47721	147	0.50
Jun-2006	26711	3489	60902	56944	170	0.47
Dec-2006	30823	4552	67048	68194	193	0.21
Jun-2007	39986	6018	79858	87407	227	0.20
Dec-2007	41589	6632	88940	93193	248	0.64
Jun-2008	35158	6049	87235	85181	248	1.45
Dec-2008	23440	5223	81461	45537	233	8.60
Jun-2009	20644	4513	72113	52008	227	1.15
Dec-2009	21608	4124	72421	60045	260	0.44
Jun-2010	20696	3403	64426	54584	239	1.23
Dec-2010	19240	2989	65571	57412	231	0.62
Jun-2011	18084	2463	62940	52500	216	1.01
Dec-2011	15078	2197	59717	44316	208	0.92
Jun-2012	13565	1463	57093	41900	190	1.13
Dec-2012	11302	350	55880	42343	162	0.72
Jun-2013	11416	357	52836	41683	162	1.20
Dec-2013	11485	405	54691	45998	155	0.75

Source: Reserve Bank of Australia, February 2014

Outside of financial products, there is a commonly held view that Australian retail investors invest a substantial amount of their assets in real property including principal place of residence and investment properties.

Changing Structure of the Retail Investment Industry

The GFC has had a significant impact not just on the way that retail investors perceive financial markets and the relative safety of particular types of financial products, but also on the way in which financial institutions, financial advisers and other intermediaries are perceived. This is less marked in Australia than in some other countries, particularly Europe and the United States where retail investors were much more directly affected by the conduct of financial institutions and their employees. But there is a level of scepticism in Australia about the value of financial advice and the perceived self-interest of financial advisers.

It is widely acknowledged that many retail investors do not routinely seek advice about their financial circumstances. This kind of strategic advice does not always entail the giving of advice about particular products, nor does it always result in the retail investor acquiring a financial product.

This disinclination to obtain advice can be linked to a number of factors. First, there is a certain level of distrust about the motivations of financial intermediaries. Second, as demonstrated by ASIC research into consumer behaviour, there are a percentage of investors who do not believe that they need assistance to make financial decisions. Third, many investors do not consider that they have sufficient assets to warrant the cost of obtaining financial advice, and may not see the benefits of advice in regard to building wealth.

Fourth, a large range of information is now available to investors through electronic means which lessens the level of reliance placed on advisers to provide information that investors need to make investment decisions.

Steve Karpin, former CEO of CommSec, when asked about generation Y and Z customers, said in an article in the Australian Financial Review in 2012 that "..they are more optimistic , more ambitious and more willing to back their own decisions. They understand the principles of diversification, they average about 10 stocks. They like to trade primarily online, they don't speak with us very often. They have a greater interest in mobile apps. We see a disproportionate share of our younger customers using our mobile trading platform, not just for trading but for information."[48]

Fifth, the cost of obtaining financial advice is perceived to be high. This is compounded to some extent by investors having previously been accustomed to advisers and other intermediaries receiving their remuneration through indirect mechanisms such as commissions and management fees, rather than the investor paying an up-front fee for financial services. Legislative reforms such as FOFA have resulted in a move away from these indirect remuneration arrangements, and have

[48] 'Waiting for the call, but it's unlikely to be good news', Weekend Australian Financial Review, 28 January 2012

made the actual cost of providing financial services much more stark to retail investors through fee for service models that require payment from the client, rather than a deduction per se from the capital amount invested or from the earnings of the investment on an ongoing basis.[49]

It is difficult to obtain precise data about the cost of providing financial services, particularly at a time where there are quite substantial regulatory and compliance changes still being implemented by industry, but it has been estimated that a full financial plan can cost in the range of $3,000 to $5,000, depending on the needs of the investor and the nature of the advice sought.

A recent study by CoreData suggests that the extra time spent on administration and compliance by Australian advisers compared to global advisers is costing them more than an extra $15,000 per year. Administration and compliance make up about 30 per cent of Australian advisers' total time, compared to a total international average of 19.5 per cent.[50]

It is inevitable that additional costs imposed by regulatory change and increased regulation are passed on to consumers.

Along with general market conditions and technological change, the high cost of regulation in Australia is contributing to structural change within the industry.

Intermediaries that are market participants have seen a substantial increase in compliance costs following the shift of responsibility for market supervision from ASX to ASIC in 2011. While there were undoubtedly good policy grounds for market supervision to be undertaken by the regulator (or a third party) rather than a market operator who is in competition with other market operators, the advent of cost recovery by ASIC is an overlay of cost that did not previously exist in the system.

Market participants who advise retail customers must comply with the FOFA reforms, albeit that there are some exemptions that relate to the distribution of stamping fees from capital raisings, and to the way revenue from brokerage fees is distributed by a licensee amongst its employees/representatives. It should be noted, for the sake of clarity, that brokerage fees at the point they are paid to a licensee have never been treated as conflicted remuneration under FOFA, as brokerage is an up-front fee for service paid by the client. The exemption relates to how the licensee passes on some or all of that brokerage to its employees/representatives as these payments are commonly based on a grid system that is linked to the volume and value of business written by the adviser.

Implementation of the FOFA reforms has come at a high cost to industry and it is far from certain that the purported advantages of the reforms such as lower cost advice for customers will eventuate. AFMA members report that successive waves of reform in relation to financial services have at each stage introduced new costs to the system, and have not resulted in lower costs for clients.

[49] FOFA still permits asset based fee arrangements and ongoing fee arrangements in some circumstances.
[50] 'Compliance costs Aussie advisers $15K versus global peers' www.financialstandard.com.au, 4 March 2014

These costs, combined with poor market conditions for a number of years after the GFC, mean that more traditional models of stockbroking business are becoming unsustainable. As a result, many market participants have sought to modify their business model and offer a broader range of services as “wealth managers”. This business model is less reliant on revenue streams from the market performance of a particular asset class but is high touch in terms of the level and frequency of services offered to customers. By its nature, wealth management is available to a smaller pool of clients than traditional broking. It is also homogenous to some extent and consequently the sector is highly competitive. It is likely that further consolidation in the broking industry will occur in the near to medium term.

AFMA members have also indicated that Australia’s comparative advantage as a jurisdiction that is well-regulated and has a clean legal system is being eroded by the increasing cost of providing financial services, in comparison to regional neighbours such as Singapore and Hong Kong. The cost of doing business, including compliance and regulatory costs, is a primary factor in decisions by financial institutions about where to locate front, middle and back office functions. As a result of technological advances, physical location is no barrier to doing business even with retail customers, who will over time increasingly prefer electronic interaction.

9.2. Regulation of Financial Services

The Disclosure Regime

There is a widely held view amongst regulators, industry participants and consumers of financial services that the disclosure regime in Australia is flawed, as it is overly reliant on an investor reading all of the material that the law requires to be provided to them, and that they understand all of the information. However, events including a number of high profile collapses of financial institutions and managed investment schemes, and a range of research in investor behaviour demonstrate that this is not always the case.

While these concerns have been raised for a number of years, there is presently no clear answer to this debate. It is worth considering a number of factors that have become evident from Government-led inquiries and from the regulatory actions taken by ASIC in recent years.

First, the Australian disclosure regime imposes obligations on issuers of financial products and on advisers who provide financial services to retail customers. The disclosure obligations are to a large extent principles based. This results in disclosure that is tailored by the product issuer, and which is not uniform to disclosure by issuers of competing products. This can make it difficult for investors to compare like products.

Second, a product issuer may comply in full with their disclosure obligations under the law, but it does not follow that an investor will understand all of the information provided by the product issuer.

Financial investments typically involve a trade-off between risk and return, which cannot be avoided. The disclosure regime cannot protect an investor from the risk of loss, and nor should it try to;

rather it should ensure that an investor can access information about the potential risks and return of a product. However, there appears to be a segment of the community under the misapprehension that it is the role of the regulator, and ultimately the Government, to protect them from loss. Consideration needs to be given to whether the current disclosure regime, and the way the regime is enforced, is serving the interests of the community.

Third, a tension has emerged in the last few years between the role of a product issuer who meets all of its existing statutory disclosure obligations under the law, and ASIC's expectations about what a product issuer will do above and beyond those obligations. To put it simply, there is a gap between the statutory obligations and ASIC's expectations. One of the clearer examples of this in recent times is the pressure by ASIC on providers of CFD products to conduct suitability testing to determine whether customers are able to understand CFDs. This expectation is set out in an ASIC regulatory guide[51], and providers are required to explain in their product disclosure statements whether or not they meet the criteria in the guidance. In practice though, AFMA understands that adherence to the guidance is not universal across the industry and that ASIC is not actively pursuing compliance. This has created an uneven playing field for providers who are attempting to meet the higher expectations, as business is lost to other providers who are not conducting suitability testing.

In any circumstance where a product issuer or adviser self-imposes additional obligations, or has those obligations imposed on them, that issuer or adviser will incur additional cost compared to other industry participants who are not meeting those additional obligations, particularly where there is no consequence for not meeting the additional obligations.

Fourth, ASIC also increasingly expects a range of participants across the financial services sector to behave as what it has described as "gatekeepers". This term has no meaning in, and has no basis in the Corporations Act, creates confusion for industry about what it is expected to do in order to meet standards that for the most part have not been articulated by ASIC, and seems to imply in some circumstances that the operation of a revenue-generating business (which is otherwise lawful) is of lesser importance than the outcome for the customer.

To the extent that there are any gaps in the current statutory obligations in the disclosure regime in Australia, it is desirable that these be properly analysed through a Government policy-making process, and addressed where this is needed. Any resultant changes to legislation may be preferable to a subjective and uneven approach taken by the regulator, for the reasons described above.

[51] Regulatory Guide (RG) 227 *Over the counter contracts for difference: Improving disclosure for retail investors*, ASIC, August 2011

Licensing and Barriers to Entry

Another area that AFMA suggests could benefit from review is the financial services licensing regime.

It is widely held by AFMA members that it is easy to obtain an Australian Financial Services License (AFSL) and that it is not an effective barrier to entry for less desirable participants.

Currently, the Corporations Act operates such that ASIC must grant an AFSL if the requirements set out in section 913B of the Act are met. These requirements focus on the good fame and character of the applicant and the sufficiency of resources to carry out the proposed financial services business. The licensing process does not look to the risk profile of the business or the level of risk attached to the financial services to be offered, albeit that anecdotal evidence indicates ASIC is attempting to look more closely at these issues than it may have done in the past.

The licensing process also does not encompass any consideration of how customers will be treated by the licensee and whether the customer is likely to achieve a good outcome by dealing with the licensee. Of late, ASIC has started to expound a concept of "treating customers fairly"[52] in its post-licensing compliance interactions with licensees.

The licensing regime should be reviewed to ensure it continues to provide a structure that meets community expectations about the types of persons/entities that are permitted to operate a financial services business, and particularly where those financial services are provided to retail investors. The review could consider whether:

- Additional initial criteria should be included in the law that must be met in order to obtain a license in the first instance;
- Capital requirements should be imposed;
- There is scope to require licensees to have different compensation arrangements in place for investor protection; and
- There are other factors that ASIC should be able to take into account when considering an application for a licence.

ASIC Resourcing for Industry Oversight

Effective oversight of financial markets is vital to Australia's reputation as a place to do business. ASIC's remit in terms of retail investor protection is very broad, and covers a large range of financial products. However, the resources that can be allocated by Government to administration and enforcement of the law are finite, in the face of many other competing economic priorities. Accordingly, regulators should focus the use of taxpayer funds on the areas that pose the greatest risk, and more importantly, systemic risk rather than more niche concerns.

[52] The Financial Conduct Authority (formerly the Financial Services Authority) in the UK is the leading proponent of "treating customers fairly".

For example, looking again at the figures on page 113 about the number of investors in what ASIC has deemed to be 'complex products', it is not clear that this small segment of the market warrants the level of scrutiny and regulatory attention it has received of late, compared to the relative lack of resources applied to the oversight of almost 4,800 licensees who are licensed to provide personal and general advice to retail investors.[53]

Retail and Wholesale Investors

At the core of all financial services regulation is the distinction between retail and wholesale investors. The Corporations Act imposes substantially higher obligations on financial services providers who deal with retail customers.

Significant business systems and processes are aligned to the way a retail investor is currently defined in the Act. However these measures have been in place for some time without review[54], and it is not clear they remain appropriate in today's economic environment.

AFMA encourages the Government to complete the review of the definition that was commenced in 2012, given that it is a key element of the Act.

[53] ASIC Annual Report 2012-13, page 13
[54] A Government options paper was released in 2011 but there has been no progress that industry is aware of since that time.

SECTION 10 – Industry Standards and Professionalism

KEY POINTS

- The effective operation of the financial system is dependent on the competence of participants and trust in their capacity to provide their services in a secure and fair way.
- AFMA supports the consideration of a broad framework for promotion of industry standards of competence and professionalism in the provision of retail financial services that benefits licensees and their representatives, as well as consumers.
- The delineation between retail and wholesale clients remain as a cornerstone of financial regulation.
- The Government should work with the financial services sector to support an industry-based approach to professionalism in the wholesale market.

10.1. Introduction

The effective operation of the financial system is dependent on the competence of its participants and trust in their capacity to provide their services in a secure and fair way. Whether it is an institutional dealer assessing the operational risk of doing business with a trader in another institution or a retail client seeking to rely on advice being given to them by a financial planner about the allocation of superannuation investments, the business will only take place if they have confidence in the competence and trustworthiness of their counterpart. Thus, a professional approach by persons involved in the industry is necessary for the full range of financial activity to take place efficiently (or at all in some cases) and, thus, is central to the success of the financial system in serving the needs of the real economy.

Australian financial services licensees have an obligation under the Corporations Act to:

- Do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly [s912A(1)(a)];
- Maintain the competence to provide those financial services [s9124(1)(e)]; and
- Ensure that its representatives are adequately trained, and are competent, to provide those financial services [s912A(1)(f)].

This section looks to explain the key settings within this framework that will promote professionalism in the industry going forward, both in the retail and wholesale sectors.

10.2. Retail Issues

Since the full implementation of the Financial Services Reform Act in 2002, many licensees have relied on ASIC's Regulatory Guide 146 Training Register, to assist them in determining which training and educational programs might be suitable for their representatives to undertake so that the statutory obligations noted above are met.

ASIC was initially reluctant to implement the Training Register, and since that time the Register has not been without issues. This is acknowledged within the industry. For example, there has been considerable concern about courses that purport to qualify a person to be a financial adviser within a very short time period. There are also concerns about the quality of some courses, and whether they actually help candidates develop skills and competencies *which are properly assessed*, rather than just imparting information.

However, the Training Register has been a useful reference for industry in deciding which courses and programs to utilise for training purposes.

In April 2011, ASIC released Consultation Paper 153[55] about its review of Regulatory Guide 146 and the training standards. It was in this consultation paper that ASIC introduced the concept of a national examination for advisers.

AFMA's response to the consultation paper was generally supportive of the need to raise standards of professionalism and training in the industry. However, a number of concerns were raised, based in part on AFMA's experience as a Registered Training Organisation (RTO), about assessment of competency and whether it can be properly assessed by a national exam.

The central question underpinning Consultation Paper 153 is how professional competence can be identified and assessed. This question is critically important to all authorities responsible for licensing professionals, most particularly in medicine and the finance industry.

The question itself cannot be answered without addressing the more fundamental question of what is competence. In the Australian vocational education framework competence is used as a catch-all concept to cover all of the skills, knowledge and attitudes needed to perform a particular job role or function. In competency-based education, competence is assessed by judging how well an individual has applied knowledge and skills in a workplace setting.

Competent individuals can generally:

- Apply knowledge, skills and attitudes in a range of familiar situations;
- Deal with the responsibilities and expectations of the workplace;
- Use problem solving skills to handle unforeseen and ambiguous situations; and
- Transfer their skills and knowledge to new situations.

Considerable research has been conducted into professional competence and expertise; the research literature on competence consistently finds that the distinguishing feature of competent professionals is not how much they know but their ability to use their knowledge. Donald Schon — perhaps the most important writer in the field of professional learning — considers professional competence is more than factual knowledge and the ability to solve problems with clear-cut

[55] ASIC Consultation Paper 153 Licensing: Assessment and professional development framework for financial advisers

solutions; it is also the ability to manage ambiguous problems and to make decisions with limited information.

Knowledge, although an important component of competence, does not in itself constitute competence. Interestingly, some theorists argue that some kinds of knowledge are more important than others for competence. For example, Michael Polanyi argues that competence is defined by tacit rather than explicit knowledge, that which we know but do not normally explain easily, like the use of rules of thumb and intuition.

A national exam can be a reliable and valid method of assessing explicit knowledge and some cognitive processes such as application and interpretation, both clearly important components of professional competence. However, knowledge and abstract problem-solving skills do not in themselves constitute competence. For example, while an adviser may know what a share is and how to calculate a dividend stream, it does not mean that they can competently devise investment strategies that are both compliant with their firm's operational guidelines and meet the needs, objectives and risk profile of a client. Competence of this nature cannot be assessed in an exam. The most valid methodology for evaluating an individual's competence is to assess how they perform in the workplace. This is because competence is context-dependent and involves applying knowledge, skills and attitudes in an authentic professional situation.

One of the strengths of the current RG 146 adviser accreditation scheme is that the training courses run via the vocational education sector are based on teaching and assessing the competence (ie the knowledge, skills and attitudes) required to advise a client — not just the formal explicit knowledge of advising theory.

There was a great deal of feedback to ASIC from across the industry about the proposals in the consultation paper. Consequently, the proposed start date of July 2012 for the national examination framework did not proceed.

In September 2012 , and unfortunately without prior notice to industry, ASIC turned off the Training Register – that is, the register was frozen at that point in time and no further courses or programs were able to be submitted to ASIC for inclusion from that time onwards.

ASIC subsequently released Consultation Paper 212[56] in June 2013, which proposed a multi-regime approach to minimum training standards. In brief:

- Regime A applied to existing advisers who did not want to change their advice activities;
- Regime B applied to existing advisers who did decide to change their advice activities between 1 July 2015 and 31 December 2018; and
- Regime C applied to new advisers after 1 January 2019, or advisers who change their advice activities after that date.

[56] ASIC Consultation Paper 212 Licensing: Training of financial product advisers – Update to RG 146

In conjunction with a number of peak industry bodies, AFMA raised fundamental issues with ASIC about the proposals in Consultation Paper 212. The primary concern raised by the industry bodies was that the ASIC proposals did not provide for a holistic approach to lifting standards of professionalism and competency – rather, the proposals only addressed the kinds of qualifications that an adviser should hold.

10.3. Promoting Retail Industry Standards and Professionalism

The current position, as AFMA understands it, is that ASIC will not be proceeding with further work in this area, and that the Government intends to consider the appropriate approach to professionalism and competency in the financial services industry. AFMA supports the consideration of a broad framework that benefits licensees and their representatives, as well as consumers.

The Corporations Act obligations on financial services licensees to ensure that representatives are competent are not the same as analogous professions (eg. accountants, lawyers and medicine) who must obtain and maintain an externally mandated qualification and must undertake minimum levels of continuing professional development in order to continue to work in their profession.

The introduction of similar requirements in the retail financial advice industry will likely only be achieved through a longer term approach and generational change, but is necessary in order to improve the professionalism of the industry and promote investor confidence.

10.4. Wholesale Markets

The level of professionalism in the wholesale financial markets reflects the competence and trust of the individuals involved. In this respect, it is similar to retail financial services, however, the relationship between two institutional traders dealing with each other is very different to that which exists between a retail client and their financial adviser. The imbalance in knowledge and sophistication between two traders is much less, if any, and there is greater reliance on the counterparty trading in a manner that is in keeping with good market practice (as well as the law). Moreover, given the scale and dispersion of trading in many institutional markets, dealers have a significant responsibility to support the efficiency and the integrity of the market place.

Similarly, the law recognises that institutional and wholesale clients who interact with their advisers do not require the same level of protection afforded to retail customers, as institutional clients are generally highly sophisticated and have a range of resources at their disposal to assist in making strategic and investment decisions.

The current regulatory framework recognises that wholesale markets do not require the same level of government intervention as retail markets. Of course, the law does provide protection against harmful practices like insider trading, market manipulation and misleading and deceptive conduct and this is absolutely essential to the effective operation of the wholesale market. However, within this framework, the wholesale markets are much more amenable to industry of its own volition adopting practices and promoting conduct that will support the efficiency and integrity of trading on the wholesale markets. For example, through AFMA the institutional OTC markets have developed infrastructure in the form of standard documentation (including credit support annexes) and trading conventions that enable the efficient and safe operation of the markets.

In relation to standards in the wholesale and institutional sectors, there is significant government and public focus on shortcomings that have come to light in relation to standards of conduct in the global markets. Against this backdrop, it is appropriate for the Australian industry to ensure that its industry standards for conduct and competency of traders in the local market are well-designed and support continued confidence in the markets. Traditionally, the industry has liaised and worked closely with the financial regulators in the development, maintenance and management of these industry conventions. Given the issues encountered in the global markets and the exceptional pace of change in OTC industry consequent to regulatory reform, it is essential to build on these relationships going forward and to actively promote the widespread adoption of good industry practice.

BOX 10.1 – Programs for Professionalism in the Wholesale Markets

AFMA is a Registered Training Organisation and provides a range of education and training services to promote professionalism in the financial markets. Our programs include, amongst other things:

- Financial Markets Accreditation for front office staff, who deal in the financial markets;
- Operations Accreditation for back-office staff, who manage trade verifications, confirmations, settlements and reconciliations.

AFMA also offers a range of continuing education programs covering diverse topics such as financial products and their mathematics, regulation and compliance and risk management – see http://www.afma.com.au/learning/ce/workshops.html . These programs promote professionalism in the markets.

AFMA regularly updates its programs to reflect changes in the industry and new developments. For example, noting the global focus on financial benchmarks, AFMA is developing a series of workshops to assist banks, brokers and staff to manage their responsibilities in relation to financial benchmarks.

These programs are examples of areas where industry can put in place expectations about standards of behaviour and the minimum competencies that are required for the performance of roles in the wholesale markets.

This approach is consistent with the distinction in the Corporations Act between the needs of retail and wholesale clients and the level of protection that is afforded to them. Accordingly, the delineation between retail and wholesale clients should be preserved as a cornerstone of financial regulation and, in this context, government should work with the financial services sector to support an industry-based approach to professionalism in the wholesale market.

SECTION 11 – Australia as a Location for Financial Services Businesses

KEY POINTS

- The income and employment benefits of the financial services industry provide a strong incentive for the Government to ensure that as much of this activity as possible takes place in Australia.
- There is great potential to expand financial services exports within the Asian region but there is also strong competition for mobile financial services business.
- The Government should give a firm commitment that it will give a high priority to measures necessary to sustain an internationally competitive financial sector and communicate this, together with expectations and targets, to its relevant agencies.
- A Treasury Minister should be given responsibility to champion Australia as a financial services centre, both within government and externally and to work with State counterparts to coordinate policies to promote Australia's financial sector.
- The regulatory and tax recommendations in the Johnson Report should be implemented and other measures since sought by industry to improve Australia's competitiveness should be examined.

11.1. Background

As outlined in Section 1 of this submission, the economy requires a broad range of financial services to operate effectively; however in many instances these services are capable of delivery from outside of Australia. The income and employment benefits of the financial services industry provide a strong incentive for the Government to ensure that as much of this activity as possible takes place in Australia. In addition, Australia has the potential to become a bigger exporter of financial services, especially by taking advantage of the opportunities presented by the Asian economic development.

This will not be easily achieved, as there is significant competition for mobile financial services business in the Asia Pacific region, with centres like Singapore having highly developed and supported policy programs to attract business to their financial centres. Moreover, similar to the experience of the manufacturing, tourism and other industries, the international competitiveness of the Australian financial sector has been adversely impacted by the appreciation of Australian dollar. International banks and other firms have a choice about the jurisdiction in which they will base their trading and back-office operations. There is evidence of offshoring of some operations connected with transactions on Australian financial markets post the GFC.

These challenges emphasise the absolute necessity for Australia to build on its strengths by developing a clear strategy to attract business and giving an absolute political commitment to take the necessary steps to implement the strategy as a priority.

For instance, Australia is a hub for financial market traders that rely heavily on electronic trading, reflecting our capable and skilled workforce, good regulatory and legal reputation and the quality of lifestyle. Australia has a range of other comparative advantages, including expertise in financial markets risk management and a time zone that may enable us to leverage on this strength. The Government can use these and other competitive advantages, like the scale of our superannuation system and the efficiency of our financial markets, as leverage points from which it can frame the policies necessary to build our international competitiveness as a financial centre. We have performed below our potential as an international financial centre to date, with Sydney and Melbourne both slipping well down financial centre rankings[57], but there is an opportunity now to recover some ground.

Before setting out the policies that the Government should consider adopting in this area, it is useful to first consider in more detail the context within which these polices need to be placed.

11.2. Asian Century Opportunities

As outlined in Section 3, the 'Asian Century' presents an opportunity to build a presence in the Asian financial system that is commensurate with our skills base, our comparative advantage in sophisticated financial services and our economy.

A facet of increasing incomes in Asian countries is that it is likely their financial markets will deepen and grow more quickly than their GDP. This reflects the changing finance and risk management needs of business, driven by factors including international trade (including intra-regional trade), and the greater demand for banking and wealth management services from individuals. It will also involve financial innovation to broaden the range of financial instruments available to investors and an opening of their financial markets to enhanced competition. This will require capacity building within financial institutions and markets, which can draw on experience gained in the mature, developed economies, like Australia.

The economic development of China and the internationalisation of the Renminbi (RMB) presents a particular opportunity for the export of Australian financial services and for investment into Australia through the banking and financial markets. China is forecast to be soon be the largest global economy and the RMB is likely over time to become a major trade invoicing and settlement currency, with significant RMB business in trade financing and RMB foreign exchange trading and hedging products. China's capital markets are expected to develop significant scale in a global context.[58] Australia's close trading ties with China and funds management expertise provide strategic advantages that we can build on.

More generally, the Asian capital markets are becoming more integrated and forums like ASEAN and APEC are promoting this process. The overall objective for Australia should be to promote

[57] See http://www.longfinance.net/images/GFCI15_15March2014.pdf

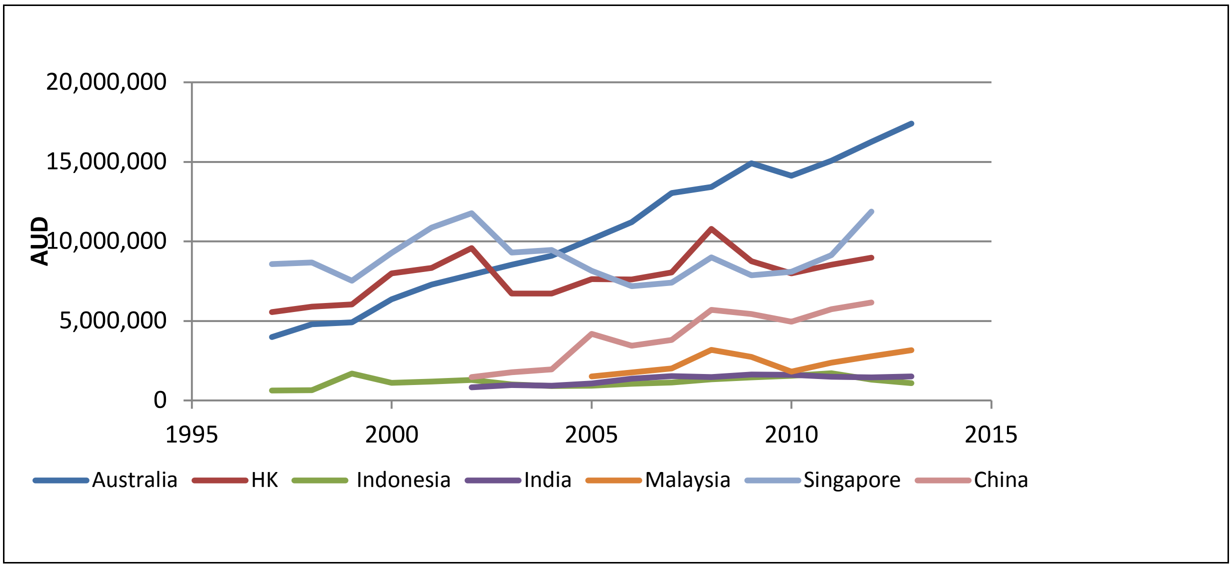
[58] The Centre for International Finance and Regulation Report on Internationalisation of the Renminbi, March 2014, gives valuable commentary on the development of China financial system and potential benefit for Australia – see http://www.cifr.edu.au/assets/document/CIFR%20Internationalisation%20of%20the%20RMB%20Report%20Final%20web.pdf

development of Australian financial markets through participation in the process of Asian financial market integration.

The Australian financial system is highly developed in global terms, both in terms of products and services offered and the organisation of the entities that provide them. The scope for further Australian financial markets development driven by fast economic growth and growing sophistication in financial markets in Asia is significant. In doing so, we can build on our existing and developing capabilities.

For example, the developed nature of Australia's financial system is reflected in the productivity of Australian bank employees. Bank assets per employee in Australian banks (in AUD terms) are higher than for banks elsewhere in the Asian region, except for Japan, and have exhibited steady growth since the late 1990s - see Figure 11.1. Income per employee shows a similar pattern. This may reflect a number of factors including benefits of scale and higher productivity and is reflected in higher wages paid to Australian employees.

FIGURE 11.1 - Asian Region – Bank Assets per Employee



For Australian Banks, the cost per employee has tracked almost exactly the assets per employee since 1998. The implication is that Australian banks employees are being paid to assume more responsibility and the more assets per employee, the higher the wage paid.

The integration of the Asian and Australian markets is still in its infancy in some respects and the potential for growing these links to assist the national economy presents a commercial challenge for business and a policy challenge for the Government. The employment and income growth from financial services exports that this could reasonably be expected to generate will only eventuate if the appropriate policy settings are put in place to enable firms in Australia to identify and leverage these opportunities.

The Asian potential is a significant but welcome challenge for firms participating in Australia's financial markets, as the trend has been to conduct less traditional back office functions in Australia and a greater amount of trading activity is done from particular centres in the region. Cost advantages alone are not enough to attract business to Australia because other financial centres, like Singapore, offer significant tax incentives and seem more committed to maintain the conditions necessary for an internationally competitive financial sector.

11.3. Getting the Right Policy Settings

The employment and income growth that should accrue to Australia from financial services will only eventuate if the Government has put in place the necessary policy settings.

Australia has a demonstrated capacity to develop the kind of innovative policy that is required to retain a strong domestic market and build financial services exports to Asia and elsewhere. However, we have not made this outcome a priority in the past and by falling short in our execution we have lost business to overseas locations.

With this in mind, we suggest the Government should give an unequivocal policy commitment to developing our financial services exports. This would build confidence in firms considering Australia as the location servicing the growing Asian market. In addition, the Government should take steps to ensure its departments and agencies are given the necessary leadership and resources to implement this policy commitment to full effect.

Australia needs to improve its performance in assessing, adopting and implementing policy initiatives if we are to capture the full benefit of Asia's expected growth through employment and income benefits for Australians from financial services industry exports.

The challenges in the financial sector are particularly significant. In contrast to many other sectors, equality of costs with other jurisdictions, or even lower costs, is not enough of itself to attract business to Australia, as financial centres like Singapore and Hong Kong offer significant and entrenched taxation incentives to financial institutions, resulting in greater confidence in their ability to maintain a competitive position as a financial centre.

Because it is not feasible to match the low business taxation rates offered in these centres in the absence of major structural tax reform, it is essential that other factors within our control that impact Australia's competitiveness as an international financial centre are managed in a highly effective way. In this manner, Australia's natural commercial capability to service Asia's growing economies and the global financial markets is not impeded.

Australia has quite an innovative policy development history in the area of international financial services. However, our record in demonstrating a genuine commitment to the concept across all levels of government and in effectively implementing associated policy measures is mixed. For instance, the offshore banking unit regime (OBU) was revamped in 1992 and later extended in 1998 as part of the 'Investing for Growth' strategy but implementation of planned reforms was incomplete and subsequent contradictory policy and administrative actions have undermined the competitiveness of the regime.[59] It is hardly surprising that the OBU regime generates less income and employment for the economy than was originally anticipated.

More generally, the low priority sometimes given to measures to address identified problems in the application and the administration of rules affects our standing as an international financial centre and is therefore a matter of ongoing concern.

For instance, the Johnson Report in 2009 recommended abolition of the LIBOR cap[60], but this initiative still remains in policy limbo. The LIBOR cap penalises foreign bank branches and hinders banking competition and its effect is becoming more severe as the Basel III banking reforms are implemented. There is no sensible policy or administrative rationale for the LIBOR cap but the issue has been left unaddressed for almost a decade now.

Australia's current capability to make policy change to promote productivity and competitiveness does not align with the time frames required in business decision making. As an industry body we are aware of members' frustration on occasion about the time taken to implement necessary change or for individual firms to receive a decision or an authorisation from a government body that we are told is processed much more quickly in competing centres, like Singapore.

In our experience, too often good policy ideas do not translate into law with the speed and effect that is necessary to best serve the economy. In contrast, proposals to further regulate the financial sector or to protect tax revenue seem to be pushed through with relative speed. The overall effect works against our international competitiveness. Moreover, delays in the implementation of beneficial policy innovations causes Australia to lose its first mover advantage and actually undermines Australia's competitiveness, as other jurisdictions more efficiently implement the innovation and attract financial services participants accordingly.

11.4. Policy Recommendations

Over the past two decades, the industry has consistently emphasised the paramount importance of a genuine commitment by the Government to the objective of Australia as a financial centre, followed by action to create and maintain the conditions necessary to support a vibrant centre. This is necessary to give potential business entrants confidence that the Government is willing to engage with them and to deal with their issues efficiently and effectively. In practice, this means that the policy objective of supporting international financial services businesses is given due recognition in the formation and implementation of government policy. This is an area where the Asian Century consultation process may be of assistance to the Government, as measures to promote effective outcomes for the Asian initiative will also have application to the broader financial centre objective.

[59] For instance, the foreign income tax offset rules in Tax Laws Amendment (2007 Measures No. 4) Act 2007 were a setback to the competitiveness of the OBU regime. Another example is when the GST was introduced, the Government declined to make OBU transactions GST-free – the industry sought this treatment to reduce compliance costs; the tax impact would not be material.

[60] Part IIIB of the Income Tax Assessment Act 1936 limits tax deductibility of interest paid by a foreign bank branch to its overseas parent for intrabank funding to the LIBOR rate.

To give confidence to firms who might consider Australia as the location for their regional businesses:

- The Government should give an unambiguous commitment that it will give a high priority to measures necessary to sustain a competitive international financial sector;
- The Government should mandate a Treasury Minister to champion Australia as a financial centre both within government and externally; and
- The Government and opposition parties should agree that the international competitiveness of the financial sector is in the national interest and work on a bi-partisan basis to implement policy measures and to promote Australia internationally.

To ensure that its policy measures are fully effective and implemented:

- The Government should communicate its policy intentions, expectations and targets in clear terms to relevant departments and agencies, including Treasury and the ATO;
- The Government should adopt a strategic focus on developing the capacity of its bureaucracy to support the design and implementation of its Asian Century objectives, particularly in respect of financial services;
- The Government should work with state governments, notably in NSW and Victoria, to develop policies that support the international competitiveness of the financial sector and to promote Australia on a coordinated basis; and
- Many foreign jurisdictions have strong track records in developing and supporting their financial services industries - the Government should seek to systematically import international best practice to be used to the local industry's advantage.

11.4.1 Specific Tax & Regulatory Measures

Australia as a Financial Centre - Johnson Report

The Johnson Report in 2009, *Australia as* a *Financial Centre – Building on Our Strengths*, has provided the Government with a good analysis of Australia's strengths and weaknesses and our potential as an international financial centre. The report includes a range of recommendations relating to tax and regulatory matters that need to be addressed to achieve our national objectives in this area. These recommendations are becoming increasingly important if Australia is to properly capitalise on the Asian Century. Progress in relation to several of the recommendations accepted by the Government is slow, so opportunities are being lost. The Government should implement these measures as a matter of priority.

It would be wrong to 'freeze frame' our potential by reference to the situation that existed during the preparation of the Johnson Report, as developments such as RMB internationalisation illustrate. The development of policy initiatives to improve our international competitiveness must be an ongoing exercise.

Managing the Tax System

There are instances in recent years where business has expressed disquiet that law change was being applied retrospectively (eg in respect of amendments to transfer pricing provisions), and sometimes without adequate consultation (eg the doubling of the withholding tax rate applicable to distributions from Managed Investment Trusts, as announced in the 2012-13 Federal Budget). Companies seeking to build businesses in the Asian markets must accept and manage significant commercial and operational risks and they should not face another layer of risk through retrospective tax law change or through the administration of the tax system. A well-structured tax system that provides certainty to business is a pre-condition to Australia taking best advantage of the Asian Century.

In addition, the tax policy and legislative process regularly fails to deal with minor or technical deficiencies in the law in an efficient way. Collectively, these occurrences are a drag on economic growth and our international competitiveness. While there is an understandable focus on major reforms and revenue protection measures, the Government should provide the necessary resources to Treasury and the Office of Parliamentary Counsel to maintain all aspects of the tax law.

Facilitating Cross-Border Business

To take full advantage of the opportunities in the Asian Century, Australian financial services businesses will seek to increase exports from Australia, invest in Asian countries and businesses and in some cases combine their operations with Asian counterparts to deliver an integrated cross-border business platform.

AFMA’s long standing position has been to support an internationally open financial system because it promotes better capital formation, innovation and competition. Australia’s financial markets currently benefit from a high level of international integration that is reflected in cross-border capital flows, financial activity and the foreign ownership of financial institutions operating here. We support the international integration of Australia’s financial markets, especially with markets in the Asian region and in the major global centres.

The laws governing our financial system provide a sound legal and regulatory framework and the Australian regulators are well-placed to administer the law in a manner that will protect the stability, integrity, efficiency and competitiveness of our markets. Key financial market infrastructure facilities in Australia should continue to be subject to Australian regulatory oversight. Further, participants have expressed confidence as to the impartiality and predictability of Australia’s judicial system in terms of addressing disputes.

Australia should address issues raised by cross-border regulatory supervision through a global multilateral mutual recognition regime. The Australian economy has benefited from an open approach in this regard through the development of our financial system and this approach will serve the economy well going forward.

Cost Recovery for Regulation

As discussed in Section 4.9 of this submission, cost recovery for financial regulation is being implemented in a way that is harmful to our international competitiveness and if the current trend continues it may well lead to more financial transactions being undertaken in offshore centres.

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