Australian Government

The Treasury

The Department of the Treasury's submission to the Financial System Inquiry

3 April 2014

Contents

Introduction

This submission responds to the Terms of Reference for the Inquiry by canvassing the performance of the Australian financial system and identifying key issues to be considered by the Inquiry. The submission is structured as follows:

An **Executive Summary** highlights the priority issues discussed in more depth in the submission.

Part 1 outlines the **objectives and functions of the financial system**. This part considers some of the principles associated with the regulation of the financial system. The discussion of the underlying rationale for regulation and how current arrangements have evolved since the previous financial system inquiry assists in considering the appropriate regulatory arrangements for the financial system.

Part 2 highlights issues affecting the effectiveness of Australia's **regulatory architecture**. A discussion of the regulatory architecture complements previous sections dealing with the strengths of Australia's regulatory approach by highlighting areas that warrant further consideration.

Part 3 canvasses the priority **sectoral issues** affecting banking, superannuation, insurance and capital markets, drawing on the discussion of the objectives of the financial system and the principles of effective regulation in earlier parts.

An Appendix covering **Australia's saving and investment balance** is provided to highlight the important role Australia's open capital account plays in enabling the Australian economy to access global capital markets, facilitating investment that has boosted Australia's capital stock and productivity.

Executive Summary

Australia's financial system has performed well

1. Australia's financial system has served Australia well in the period since the Wallis Inquiry, including in supporting growth in the real economy during the global financial crisis.

2. Nonetheless there is room to better position the financial system to respond to the structural changes facing Australia — in particular, the ageing of Australia's population — and to ensure its continued effectiveness in funding Australia's future growth and in providing businesses and households with the tools to manage risk.

The regulatory framework remains appropriate

3. A more active and interventionist regulatory environment is appropriate for the financial system, compared to other parts of the economy, because of the system's potential to disrupt the wider economy and society when it fails in its role of efficiently allocating capital and managing risk.

4. Australia's regulatory framework is sound. The framework — shaped by the Wallis Inquiry and the response to the collapse of HIH — contributed significantly to the stability of the financial system through the global financial crisis, although additional government intervention at the onset of the crisis also supported investor and depositor confidence.

5. While there is no need for fundamental reforms to the regulatory framework, improvements at the margin would foster greater competitiveness across the financial system without endangering stability.

Australia's financial regulation will continue to be shaped by global standards

6. The environment in which Australia's financial institutions operate will continue to be shaped by the decisions of global standard setters as well as national authorities responsible for the world's major capital markets.

7. As a significant capital importer whose major financial institutions access European and American markets, Australia has limited capacity to ignore these developments, especially in areas like Basel III where new standards are highly prescriptive and subject to detailed peer review.

8. Moreover, the new standards address material shortcomings that were exposed during the crisis, in particular ensuring that financial institutions are adequately capitalised and markets are more robust. Many of these reforms will bring regulatory standards in other jurisdictions into closer alignment with the Australian approach. To the extent that these reduce the risk of future financial crises, Australia will benefit.

9. That said, it is important that Australia work through the G20 and international standard setters to ensure that new standards are right for Australia and the global financial system and to guard against any tendency to over-regulate financial markets at the potential cost of growth. This includes reserving sufficient flexibility to apply new standards only where the benefits warrant them, or to tailor them to Australian conditions.

Refinements to Australia's regulation to improve efficiency and stability

10. Regulation imposes costs on business that, at least in part, will be passed onto the end users of the system and introduce distortions that lead to an inefficient allocation of resources, a reduction in competition and a reduced ability to manage risk. There is scope to reduce these costs, even if they cannot be fully eliminated.

11. In forming views about improving the regulatory environment, the Financial System Inquiry should consider the following issues:

- **ameliorating the impact of guarantees** to the banking sector that have introduced or reinforced distortions that generate moral hazard and that preference some banks over others to the detriment of competition and the efficiency of the banking sector;

- **maintaining strong supervision, which is a function of regulatory independence, balanced with appropriate accountability.** The collapse of HIH and the global financial crisis demonstrated that a sound principles-based framework combined with active supervision offers many benefits above rules-based approaches. However, the existing mechanisms for accountability should be further strengthened by defining measures of success that recognise the trade-offs inherent in the regulators' statutory mandates. The Government is currently developing a framework for assessing regulator performance drawing on work by the Productivity Commission;

- **achieving clear demarcations** between financial promises of varying intensity and between regulators whose roles are defined by this concept, namely Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC). The effectiveness of the regulatory framework

proposed by Wallis rests on clear functional lines of responsibility for the regulators. The recent proposals for ASIC to take on quasi-prudential functions following the collapse of Banksia illustrate the difficulties in maintaining clear demarcations in the face of changing products and market structures.

New policy tools can achieve more cost-effective consumer empowerment

12. A well-functioning financial system meets the needs and preferences of individuals. Yet the nature of financial products and decision making is affected by complexity and challenges in obtaining and analysing information.

13. Events since the Wallis Inquiry such as the widespread confusion around the definition of flood cover in insurance policies and the collapse of Storm Financial demonstrate that the main regulatory tool to address these issues — mandated disclosure — does not provide sufficiently meaningful and digestible information to consumers constrained by time or ability. Yet mandated disclosure involves a cost to business which is ultimately borne by customers.

- This underscores the important role for financial advisers to provide professional, high-quality and affordable information to assist consumers in engaging with the financial system.

- In forming a view on cost-effective approaches for promoting confident and informed consumers, the Financial System Inquiry should also consider:

  : the scope for promoting market solutions by redesigning disclosure requirements for the digital age to enable the growth of 'information intermediaries' that can apply expertise in presenting information in an effective and digestible way;

  : the circumstances in which tools that provide simple and low-cost options for disengaged consumers by default can achieve an appropriate balance between consumer protection, individual freedom and compliance costs.

Financial system must evolve to meet the needs of retirees

14. A significant issue before the Inquiry is the responsiveness of the financial system in meeting the expanding needs of Australians in retirement and its capacity to offer cost-effective products that enable individuals to manage longevity risk.

15. Superannuation is fundamental to Australia's retirement income policy, but the sector is focussed on supporting saving through the accumulation phase. The financial system — including both superannuation and insurance industries — has not yet

developed the range of products necessary for individuals to manage their longevity risk through the drawdown phase. This is an issue that both the Henry Review and the Cooper Review canvassed and it is timely for this Inquiry to offer a way forward.

16. The benchmarks for assessing whether the financial system is meeting the needs of retirees include:

- **efficiency of the superannuation sector**. The Australian superannuation sector is characterised by high operating costs and limited product innovation. These clearly affect the retirement incomes of Australians, though the recent policy reforms are designed to address these issues, when fully implemented;
- **adequate supply of alternative retirement income products**. Insurance companies offer a limited range of annuities, but these do not address longevity risk as they are typically for fixed terms. Annuities that promise a defined level of income but for a persons' lifetime would be very costly given the level of risk transfer from the individual to the product provider. The Financial System Inquiry should explore the scope for alternative products that offer more choice in the trade-off between risk transfer and affordability, the features of the insurance sector that prevent the development of products to manage longevity risk and to consider the appropriate role for public policy, if any, in managing longevity risk; and
- **efficient taxation of superannuation, including deferred annuities and other retirement income products**, noting that the Government has committed to reviewing the regulatory barriers to such products and to a Taxation White Paper.

17. Superannuation has evolved significantly since the Wallis Inquiry in the growth of the self-managed super fund sector.

18. Self-managed super funds allow individuals to manage their own retirement income if they choose to, and enhance competition within the superannuation sector. They involve no financial promise — intense or otherwise — as the beneficiary and trustee are the same person and are not prudentially regulated. As such, self-managed superannuation funds are appropriately subject to low levels of regulation and to oversight by the Australian Tax Office to monitor compliance with taxation law. This approach should be maintained.

Part 1: The objectives of the financial system and its regulation

Key points

1. Australia has been well served by its financial system in the period since the Wallis Inquiry. The stability and resilience of the financial system contributed to the strength of the real economy through the global financial crisis, though additional government intervention in turn supported stability in the financial system.

2. The global financial crisis confirmed that the financial system warrants special regulatory attention relative to other parts of the economy because of its potential to disrupt the wider economy and society when it fails. Agency costs and the impact they can have on the wellbeing of individuals also warrant a regulatory response to promote the efficiency and fairness of the system.

3. However, regulatory interventions can themselves carry costs that detract from the efficiency of the system and they can reduce competition.

4. The framework established by Wallis to address these trade-offs remains sound and should be the basis for regulating the financial system over coming decades. In refreshing the regulatory framework, the Inquiry should take account of developments since the Wallis Inquiry to and their impact on efficiency and stability:

    - the collapse of HIH demonstrated that vigilant supervision and a proactive regulatory culture is superior to a rules-based approach to regulation;
    - the global financial crisis confirmed the need for well-capitalised financial institutions and transparent and robust markets;
    - evolving global standards continue to shape Australia's financial regulation and, if implemented appropriately, will improve the soundness of domestic institutions and provide more assured access to global financial markets;
    - implicit and explicit guarantees affect the efficiency and level of competition in the banking sector; and
    - the emergence of more cost-effective ways to empower consumers at a time when current approaches to disclosure and financial literacy programs have reached the limits of their effectiveness.

Objective and functions of the financial system

5. The objective of the financial system is to support the growth of the real economy and to meet the needs of the businesses and households that rely upon it. Ultimately this is the benchmark against which the performance of the system should be assessed.

6. The financial system supports growth by **facilitating the flow of funds among savers and borrowers**. As part of its role, the financial system:

   - pools funds — allowing for risk diversification and for larger investment projects to be undertaken; and
   - accumulates and applies specialised expertise in credit assessment — allowing the economy to better manage risks and returns from investment, at a lower cost (that is, removing the need for each individual to undertake their own credit assessments).

7. The financial system allocates capital efficiently when it directs scarce capital towards the most productive forms of investment. Distortions within the system or exogenous to it that result in a less efficient allocation of capital will detract from the growth potential of the economy.

8. The financial system allows individuals to **pool risk and to allocate risk to those most suited to bear it**. For instance, home insurance allows individuals to pool the risks associated with losing their home; and foreign exchange derivatives allow financial institutions to shift exchange rate risk to another party more willing to bear, and manage, that risk.

9. The financial system provides clearing and settlement services that enable a more **efficient exchange of goods and services**. In addition to reducing the transaction costs of exchanging goods and services, the financial system supports settlement timeframes which significantly reduce the risk that a party receiving goods or services will default prior to a payment being completed.

10. The technical efficiency of the financial system is achieved when it delivers its services at the lowest cost.

11. Australia will be well served by its financial system provided it continues to service the needs of businesses and households. Just as the real economy is continuously changing to ensure its dynamic efficiency, the financial system needs to be flexible, adaptable and respond to innovation.

12. These concepts of efficiency are an important framework for assessing the performance of the financial system. However the scale and complexity of the system

necessarily means that such assessments will be largely qualitative in nature, reflecting judgement as well as technical analysis.

The financial system warrants special regulatory attention which involves trade-offs

13. The objective of government intervention in the financial system should be to improve its efficiency and stability.

14. To this end, the role of government should be to encourage a competitive, market-based, system that recognises the private sector's primary role in responding to customer needs. Regulatory intervention should be targeted to areas where the market is likely to fail, and where the benefits of the regulation outweigh its costs.

15. Two broad forms of market failure that warrant regulatory intervention specific to the financial system — rather than relying on an economy-wide approach — arise from:

    - systemic risk, or the negative externalities arising from the failure of a systemically important institution on other institutions within the system on the economy more broadly; and

    - agency costs that can arise where an agent pursues their own self-interest rather than those of the principal (or owner) of an asset because of an asymmetry of information or other incapacity on the part of the owner to ensure the agent's incentives are aligned with his or her own interests. Agency costs can occur throughout the economy but are particularly pronounced in the financial system.

16. Regulatory intervention to address these market failures aims to increase the stability and the efficiency of the financial system along with its fairness. However regulatory intervention can introduce costs that detract from efficiency. The challenge is to balance these trade-offs.

Systemic risk

17. The financial system provides a crucial link across all sectors of the real economy, and its smooth functioning depends on confidence in its institutional infrastructure. While the financial system is a critical link in the economy and contributes to growth and wellbeing, **it has the potential to transmit shocks and cause significant economic damage**.[1]

[1] Maddock and Munckton, 2013, 55

18. When the financial system stops functioning properly it has knock-on effects to all parts of the economy in a way that other sectors generally do not.[2] With growing connectivity among financial institutions and tighter financial and trade linkages between countries, financial shocks in one jurisdiction can rapidly spill-over across national borders.

19. These spill-over impacts were illustrated when systemically important financial institutions failed during the global financial crisis. **The costs of financial instability in terms of lost growth and forgone welfare can be significant**.[3] These effects are often long-lasting because of lower investment, unemployment and the slower growth potential of affected economies.

    - The global financial crisis was followed by significant increases in unemployment across the globe, with OECD average unemployment rates rising from 5.6 per cent to 8.5 per cent. In Spain and Greece the unemployment rate has risen to over 25 per cent.[4]

    - The Dallas Federal Reserve has estimated that in the United States, around 40 to 90 per cent of one year's output was forgone due to the global financial crisis ($6 trillion to $14 trillion, the equivalent of $50,000 to $120,000 for every U.S. household).[5]

    - The World Bank and IMF estimate that the global financial crisis has reduced the rate of poverty alleviation — keeping 53 million more people in extreme poverty by 2015 than otherwise.[6]

20. Devastating personal and financial hardship can emanate from disruption in the financial system. Financial hardship can cause permanent damage to people's relationships and health.

21. While Australia experienced a small number of isolated failures in the past decade, these failures have been financially and emotionally difficult for the people affected. A Parliamentary Inquiry in 2009 that examined the collapse of several financial companies remarked:

    Many of the people hardest hit experienced the loss of retirement savings, forced sales of family homes, breakdowns in personal relationships, inability to meet living expenses, and ill health. Some are now faced with trying to return to work at a time

[2] Debelle, 2012
[3] BIS, 2012
[4] OECD Main Economic Indicators, 2014
[5] Atkinson et al, 2013
[6] World Bank, 2011

in their lives when it would not be easy for them to find work, or when doing so will be inconsistent with their current state of health.[7]

22. Such impacts on the real economy and on society inevitably entail a response by government, which has tended to act as a 'temporary shock absorber' in a financial crisis.[8] This occurs primarily through:

- capital injections and acquisitions of failed banks;
- discretionary fiscal policy and support measures such as transfer payments, and the subsequent costs of servicing public debt.[9]

Table 1: Government support during the crisis

	Capital injections to financial sector	**Discretionary fiscal stimulus**	
	Per cent of 2009 GDP	Per cent of GDP	
		2009	2010
Australia	0.0	2.8	1.8
Canada	0.0	1.8	1.7
China	0.0	3.1	2.7
France	1.1	1.0	0.5
Germany	1.2	1.5	2.1
Italy	0.3	0.0	0.1
Japan	0.1	2.8	2.2
Netherlands	6.3	2.5 (a)	
Switzerland	1.1	0.5 (a)	
United Kingdom	6.4	1.6	0.2
United States	2.9	1.8	2.9

(a) Cumulative effect of fiscal stimulus from 2008-2010 as a per cent of 2008 GDP
Source: Reserve Bank of Australia

23. In the Australian context:

- the failure of HIH resulted in a fiscal cost of over $650 million;[10] and
- the Government stimulus introduced during the global financial crisis amounted to a fiscal cost of around 2.8 per cent of GDP in 2009 and

[7] Paraphrased from PJCCFS, 2009
[8] IMF 2012b; Stevens, 2010
[9] IMF, 2009
[10] Treasury, 2012b

1.8 per cent of GDP in 2010 (Table 1). This compares to fiscal costs of over 40 per cent of GDP each for Ireland and Iceland.[11]

Regulatory trade-offs in addressing systemic risk

24. The most efficient outcome would be where the private sector manages its own risks and is exposed to market disciplines and consequences of its own failures.

25. However, the potentially catastrophic consequences of certain types of financial failures removes the ability of markets to ensure the costs are fully contained within the entities involved or within the financial system and therefore weakens the ability of markets to provide discipline.

26. Prudential regulation is a tool that partially addresses these limitations. Regulatory tools such as capital requirements are important for achieving a more efficient distribution of risk between the public and private sector.

27. Prudential regulation is intensive and clearly involves significant costs, including:

    - the opportunity costs from compelling regulated institutions to hold capital in low-risk, low-return assets; and
    - the compliance costs associated with the intensive regulation expected of an effective regulator.

28. Nonetheless such costs — often in sharp relief when first imposed — need to considered in the context of a longer time horizon over which the benefits associated with avoiding or lessening the impacts of a financial crisis can be expected to outweigh these opportunity and compliance costs.

29. However prudential regulation faces the challenge of addressing systemic risk through the imposition of regulations on individual institutions without guaranteeing the viability of those individual institutions. This is a difficult balancing act made more complicated by the guarantees of wholesale bank funding and deposits that were instituted through the financial crisis.

30. Regulation that reduces the likelihood and consequences of a financial institution failing can reduce the incentives for the investors in that institution to monitor its management to ensure that they are appropriately managing the risk borne by the institution ('moral hazard'). Regulation that protects incumbents and reduces their likelihood of exit can reward inefficient firms and prevent capital from being allocated to its highest value use.

[11] IMF, 2012b, Figure 8

31. Prudential regulation should aim to achieve the right balance — recognising that regulation in this area requires more art than science. Greater regulatory intervention to reduce systemic risk increases the possibility that systemically important firms will take on more risk in ways not readily observable to regulators, while also benefiting from regulation that lowers their cost of capital relative to other institutions — hence distorting the allocation of capital and impeding competition.

32. Part of the solution achieving a balance is to preserve a spectrum of risk — narrowly casting the net of prudential regulation to a limited and well defined number of institutions. Another element of the solution is to ensure regulators are closely and effectively supervising developments within institutions. While some of the challenges with this approach are explored in Part 2 of this submission, recognition needs to be given to the impact of prudential regulation and supervision on efficiency.

33. The G20 and international standard setters have responded to the recent crisis by undertaking a series of reforms designed to ensure that the global financial system is more resilient, including by strengthening prudential standards and supervision. However they are also developing a regulatory response that directly targets the risks and inefficiencies introduced by the perception that some financial institutions are 'too big to fail'. This issue is further addressed in Part 3 of this submission.

Agency costs

34. Government has a further role to promote the efficiency — and the fairness — of the financial system through measures to address agency costs. Agency costs arise because the owners of assets are not necessarily the managers of those assets. This is inherent across the financial system, reflecting its natural role in pooling funds and developing specialised expertise to efficiently manage risk.

35. Agency costs arise when the managers of assets pursue their own self-interest rather than that of the investor, and can do so because the investor is unable to effectively monitor their behaviour. An asymmetry of information is one reason for this. Other reasons are canvassed later in Part 1.

36. Agency costs are particularly problematic in the financial system — and warrant greater government intervention than in other sectors of the economy — because the complexity of financial products exacerbates the difficulty for unsophisticated investors in understanding the nature of the risks and obligations they are taking on, and the severity of the impact on their financial position and wellbeing if downside risks are realised.

37. Conduct and disclosure obligations have been the regulatory tools used to address this agency problem, with those tools improving efficiency (by promoting confidence in the integrity of the market) and fairness (by offering consumers some protections).

38. However, governments and regulators need to be mindful of the costs of intervention when assessing the net benefits of policy settings, including:

    - the costs of compliance to businesses which at least in part are borne by consumers, including by businesses withdrawing services; and
    - the propensity for intervention to add complexity that can be both counterproductive and act as a barrier to new entrants.

39. A key issue before the Financial System Inquiry will be the effectiveness of disclosure obligations in addressing agency costs. This is further explored later in Part 1 and in Part 2.

Wallis addressed these regulatory trade-offs

40. The Wallis Inquiry came at a time of steady growth and relative calm in the Australian financial markets. However, the turmoil earlier in that decade and other developments indicated the framework for regulation had not kept pace with changes in the financial system.[12]

41. Key developments included:

    - an increase in financial assets following deregulation, which led to the development of markets in a wider range of debt securities, a proliferation of investment products and a more important role for institutional investors;
    - large losses in the financial sector in the late 1980s and early 1990s, and the 1990s recession — consequences of the deregulatory program put in place following the Campbell Inquiry; and
    - the growing number of institutions that operated in more than one product segment of the financial system (e.g. banking, wealth management, insurance), blurring the distinction between different types of financial institutions.[13]

42. The Wallis Inquiry found that the regulatory structure at that time was inefficient and distorted competition in the financial system. At the time, regulation was

[12] Gizycki and Lowe, 2000, 180
[13] Gizycki and Lowe, 2000, 181

institutionally-based and undertaken by a variety of Commonwealth and State regulatory agencies.

43. This structure resulted in functionally similar institutions, such as banks, building societies and credit unions, being subject to different regulation. It involved significant duplication of resources and did not provide a sound basis for regulating financial conglomerates.

Wallis Inquiry recommendations

44. Wallis argued that the financial system could be relied upon to produce efficient outcomes provided markets are competitive, prudential regulation is in place for a limited number of businesses to provide a 'safe harbour', and other financial institutions outside the prudential perimeter are subject to disclosure and conduct regulations.

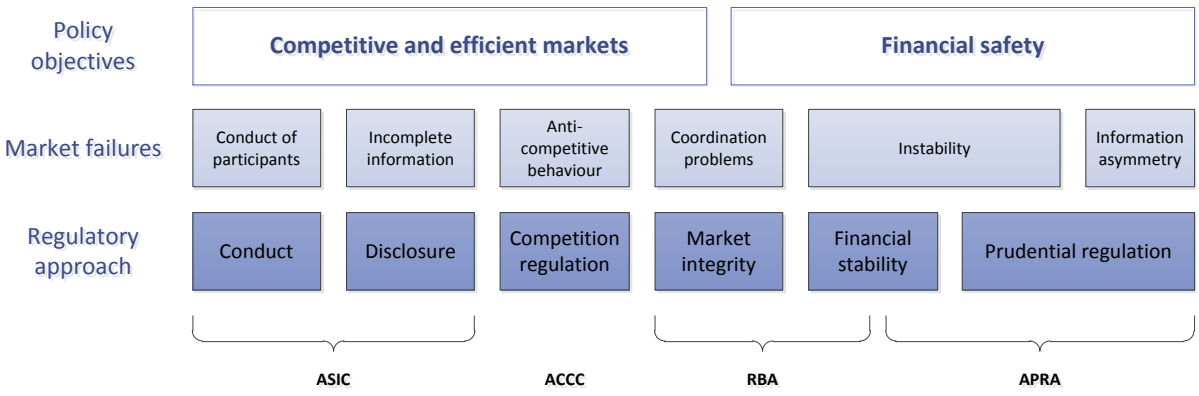
45. The Wallis Inquiry's approach to regulation was based on addressing a relatively narrow set of well-defined market failures (information asymmetry, externalities and anti-competitive behaviour).

46. Under the Wallis Inquiry's approach, it was argued that prudential regulation needed to be reserved for the most intense financial promises where breaking those promises could cause wide-spread damage to the real economy.

47. To complement this approach, the Wallis Inquiry recommended a more streamlined regulatory architecture based on functions, rather than types of institutions.

48. The relationship between the Wallis Inquiry's policy objectives and its proposed the regulatory methods are illustrated below.

Wallis Inquiry regulatory framework



49. The Wallis Committee articulated the following objectives for financial system regulation:

- **market integrity** — the financial system operates in a fair and transparent manner, absent of fraud and market abuse, and effective disclosure;
- **conduct and consumer protection** — the needs of consumers are addressed, consumer interests are safeguarded and service providers interact with customers in a transparent and professional manner;
- **competition** — markets generate efficient outcomes, with capital allocated to its most productive uses, the pricing of financial services reflecting costs, and the expected returns from financial services reflecting risks; and
- **safety and stability** — consumers can expect the most intense financial promises to be fulfilled and the financial system is resilient to shocks so the failure of one institution does not cause other otherwise sound institutions to fail.

Reforms following the Wallis Inquiry have served Australia well

50. The reforms following the Wallis Inquiry, and modified following the collapse of HIH, have served Australia well by establishing a principles-based regulatory system that targets defined objectives and is flexible to adapt to changes in the system. The regulatory system contributed significantly to the stability of the Australian financial system through the global financial crisis.

51. The reforms streamlined Australia's regulatory architecture to accommodate structural changes and innovation in markets, such as an increasing presence of financial conglomerates.

52. In addition, structuring financial system regulation along functional lines has assisted in making regulation consistent across the range of competing financial products and providers, thus fostering competition and greater efficiency in the financial system.[14]

53. The reforms also brought together similar regulatory functions from a number of Commonwealth and State regulatory authorities which has reduced duplication and inconsistency in regulation, reducing costs and complexity.

[14] Carmichael, 1999

Wallis regulatory philosophy remains valid but needs updating

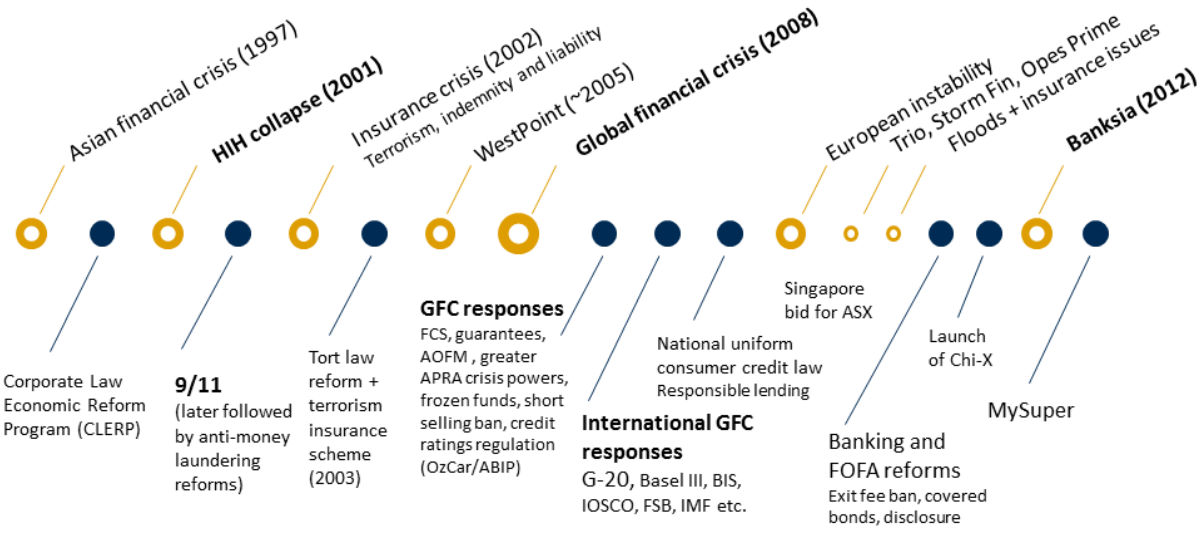
54. Nonetheless, events since the Wallis Inquiry have demonstrated the need to adjust the regulatory framework to accommodate developments in global and domestic financial systems and new approaches to consumer empowerment.

55. In refreshing the philosophy underpinning regulation of the financial system, the Financial System Inquiry should respond to:

- **the collapse of HIH** which demonstrated that vigilant supervision and a proactive regulatory culture is superior to a rules-based approach to regulation;
- **the global financial crisis** which confirmed the need for well-capitalised financial institutions and robust markets;
- **evolving global standards** that continue to shape Australia's financial regulation and, if implemented appropriately, will improve the soundness of domestic institutions and provide more assured access to global financial markets;
- **Implicit and explicit guarantees** now becoming an established feature of the Australian financial system, introducing or reinforcing distortions that generate moral hazard and that preference some banks over others to the detriment of competition and the efficiency of the banking sector; and
- **the emergence of more cost-effective ways to empower consumers** at a time when current approaches to disclosure and financial literacy programs have reached the limits of their effectiveness.

56. In addition, events have further blurred the prudential boundaries, creating a need for a clearer demarcation between the financial promises of institutions that are regulated in different ways. This is canvassed in Part 2 of this submission.

Events since the Wallis Committee prompting a need to refresh the regulatory philosophy



Effective regulation involves intensively supervised institutions

57. The collapse of HIH in 2001 revealed that a sound regulatory architecture is a necessary but not sufficient condition for fostering well-functioning markets. While the Wallis reforms assigned clear accountabilities, there were shortcomings in how these accountabilities were exercised. The Royal Commission into the collapse of HIH found:

> *"APRA's failure to act did not contribute to the collapse of HIH. However, the manner in which APRA exercised its powers and discharged its responsibilities under the Insurance Act fell short of that which the community was entitled to expect from the prudential regulator of the insurance industry".*[15]

58. In response, Australia's regulatory agencies developed a pro-active approach to regulation, recognising that supervisory effectiveness hinges on the right supervisory mindset.[16] The importance of vigilant supervision has been emphasised by the IMF:

> *The "ability" to supervise…requires appropriate resources, authority, organization and constructive working relationships with other agencies [and] must be complemented by the "will" to act. Supervisors must be willing and empowered to take timely and effective action, to intrude on decision-making, to question common wisdom, and to take unpopular decisions.*

[15] HIH Royal Commission, 2003, 442
[16] Laker, 2010

Developing this "will to act" is a more difficult task and requires that supervisors have a clear and unambiguous mandate, operational independence coupled with accountability, skilled staff, and a relationship with industry that avoids "regulatory capture."[17]

59. The independence of Australia's regulators needs to be preserved in order to ensure their supervisory effectiveness and to maintain Australia's reputation among global peers that Australia remains a safe and attractive environment in which to invest. A challenge is balancing supervisory independence and accountability — which is explored in Part 2.

The global financial crisis confirmed the importance of well capitalised institutions

60. Australia did not experience the same crisis conditions faced overseas, in part, because Australia had improved the ability of financial institutions to meet their obligations by ensuring they were well capitalised and subject to effective supervision.[18]

61. In addition, the collapse of HIH had prompted Australia to undertake extensive preparatory work on crisis management and the development of the precursor to the financial claims scheme.

62. While the Australian financial system fared better than many during the financial crisis, it was not immune. Australian banks were confronted with the same turmoil in global financial markets as their global competitors with wholesale funding markets almost fully closed.[19]

63. Despite the sound financial position of Australian institutions, global developments necessitated Government guarantees to financial institutions, funding injections to the securitisation market, superannuation funds confronting liquidity issues and a 'freezing' of redemptions in managed funds.

64. The crisis underscored the need to ensure financial institutions can meet their obligations by being well-capitalised and effectively supervised by regulators with institutional support to safeguard the financial system.

[17] IMF, 2010, 4
[18] FSB Peer Review of Australia, 2011
[19] Laker, 2010

Australia's financial regulation will continue to be shaped by global standards

65. The global financial crisis prompted countries to consider stronger financial regulation, with some governments reversing past deregulatory actions. Global regulations that were once lagging behind Australia have now ventured towards more rigid rules-based approaches which, in many ways, represent a significant leap beyond Australia's flexible, risk-based framework.

66. Australia has strong market-driven incentives to meet global standards. Australia and its financial institutions have much to gain from global reforms that improve the soundness of financial institutions and provide more assured access to global markets.

67. Australia's adherence to global benchmarks helps attract global investors. In the post-global financial crisis context, investors and their advisers demand greater transparency and will judge Australia's financial institutions against global standards. Australia's 'global citizenship' and broader international engagement objectives are also relevant.[20]

68. At the same time, the global financial crisis confirmed the benefits of ensuring the methods of implementing global standards are applicable to an Australian context. While there are benefits from strengthening Australia's regulatory framework in line with global standards, there are circumstances where these standards should provide flexibility in implementation to ensure the rules remain sensible for Australia.[21]

69. Australia's participation in global fora has resulted in modifications to international proposals to make them better suited to the Australian financial system, such as winning global acceptance for alternative approaches to satisfying the liquidity requirements of Basel III. Similar gains have been made in working with American and European authorities to reduce the compliance burden on Australian institutions active in their markets through a process of 'substituted compliance' that recognises the quality of Australia's financial regulation.

70. With the most acute phase of the crisis having passed, and significant reform progress having already been made, the G20 has agreed that 2014 is an appropriate time to begin transitioning the financial regulation agenda from that of 'crisis response' towards, ultimately, a more 'steady state' of operation.[22]

71. Australia should continue to advocate, through the G20, greater certainty in the regulatory environment to foster confidence and growth and work to ensure the

[20] Stevens, 2013
[21] Schwartz, 2013. For example, Australia is one of a minority of countries that have depositor preference, with most countries instead relying solely on deposit insurance.
[22] G20, 2014

impact of regulation beyond agreed international standards does not undermine Australia's national interest.

Guarantees have become an established feature of the Australian financial system

72. In the period since the Wallis Inquiry, governments confronted unprecedented circumstances that led to the implementation of guarantees in the financial system:

    - the HIH Claims Support Scheme, which compensated HIH policy holders following its collapse;
    - the Financial Claims Scheme, which recognised that depositors could face hardship during a lengthy wind-up process for a failed institution; and
    - guarantees of bank wholesale funding, at a time when governments around the world were guaranteeing their banks — placing Australian banks at a competitive disadvantage despite sound financial footing.[23]

73. The guarantees provided to the financial system will continue to have a lasting impact:

    - the previous government's decision to make the Financial Claims Scheme a permanent feature of the Australian financial system reinforces public expectations about the way government supports depositors; and
    - the continuing effect of the wholesale funding guarantee on the way investors, ratings agencies, advisors and analysts predict the way the government could handle future disruptions in financial markets (despite the scheme closing to new debt four years ago).

74. The experience of the global financial crisis therefore has added to the difficulty of regulating to promote the stability of the financial system without such intervention being seen as a guarantee of the viability of individual institutions. The credibility of any reforms to address this problem will be challenged by the precedents set through the crisis.

75. Nonetheless the experience of the crisis in Europe and America has demonstrated the implications of supporting financial institutions deemed 'too big to fail' (see Table 1 on page 13). Australia did not have the same fiscal costs associated with supporting the financial system — in part reflecting the robustness of the regulatory arrangements — but still faces the inefficiencies and impact on competition that arise when some institutions are perceived to be 'implicitly guaranteed' by the government.

[23] Stevens, 2010

76. This is a global challenge to which the G20 and international standard setters are collectively developing a response and is further addressed in Part 3.

More cost-effective methods of consumer empowerment are emerging

77. The financial system meets its objectives when financial businesses are driven by the needs of consumers. Yet, the premise of the current regulatory framework — adequately informed consumers making 'rational' financial decisions — fails to take account of how people actually behave, process information and use information technology.

78. The regulatory framework should be designed for its users — acknowledging that around half the Australian adult population struggles to understand basic everyday documents and forms, and are unable to understand and perform rudimentary analysis of figures in texts, tables and graphs.[24]

79. Current disclosure requirements are not effective in helping consumers make informed decisions[25] and financial literacy programs have little, if any, sustained impact on behaviour or improved financial outcomes.[26] As such, despite disclosure supporting information flows among experts within the market place, businesses are incurring compliance costs from a regulatory regime that has minimal impact on consumer empowerment, and often pass these costs on to consumers.

80. The continuing rise in household wealth and growing product choice and complexity provide further rationale for the Financial System Inquiry to consider simplifying and rationalising regulation, with a focus on:

    - **maintaining a clearly identifiable 'safe harbour'** for essential financial products such as deposits, superannuation and insurance;
    - **unlocking the potential of markets** by making information more accessible electronically to enable growth in the financial advice sector and 'information intermediaries', such as online product comparison specialists, that could apply expertise in presenting information in an effective, readily digestible way; [27]

[24] ABS, 2013, Cat. 4228.0
[25] Valentine, 2008; Ben-Shahar and Schneider 2011; Trowbridge, 2011
[26] Mandell 2006; Fernandes et al 2014; ASIC 2011.
[27] This goes beyond promoting standardised format for digitised information, and includes information technology that can aggregate quotes for a product or service in circumstances where consumers must first supply information service providers.

- **using technology, multi-layered disclosure and other interactive disclosure methods** to better allow consumers to assess risks without being overwhelmed by information; and
- **allowing consumers who are suitably engaged to access a spectrum of risk** that best satisfies their preferences, for example, considering areas where 'default' outcomes could be improved to promote regulatory goals while preserving choice, individual authority, ownership and control.[28]

[28] Sunstein, 2011, 1365

Part 2: The effectiveness of Australia's regulatory architecture

Key points

81. The regulatory architecture that has evolved since the Wallis Inquiry has proved to be sound and should be maintained.

82. The Australian financial system contributed to Australia's ability to maintain growth during the global financial crisis, in part validating the regulatory architecture proposed by Wallis and the pro-active and intensive supervision APRA developed in response to the collapse of HIH.

83. The independence of regulators to exercise their supervisory responsibilities is therefore a critical element of the regulatory system. Such independence needs to be balanced by effective accountability. The Financial System Inquiry should consider the scope to strengthen the mechanisms by which regulators account for the discharge of their responsibilities, noting the work of the Productivity Commission in developing a set of indicators for assessing the performance of regulators.

84. Market developments and policy changes since the Wallis Inquiry have blurred some of the responsibilities between the regulators, particularly between APRA and ASIC. This risks confusion about their roles and potentially reduces the benefits to industry and consumers of a regulatory architecture based on clear functional lines. It is timely for the Financial System Inquiry to address overlaps or gaps between the roles of the regulators to ensure a clear demarcation between regulators is maintained.

85. In particular, the proposed response to the collapse of Banksia in 2012 that involves a quasi-prudential regime for debenture issuers administered by ASIC rather than APRA is a significant departure from the framework proposed by Wallis. Prudential regulation should continue to be administered by a specialised regulator.

86. The blurring of responsibilities between APRA and ASIC reflects the confusion among investors as to the distinction about the extent of the prudential perimeter and the risks and protections of their investments.

87. Improving the ability to distinguish between entities regulated in different ways is likely to present the lowest cost option for dealing with this issue. The alternative, expanding the prudential perimeter to cover a larger range of businesses, is likely to invite regulatory arbitrage, and involve significant industry compliance and opportunity costs.

Independence is necessary for effective regulatory supervision, but needs to be balanced by accountability

88. The regulatory framework established by Wallis contributed to the stability and resilience of the Australia's financial system and its economy through the crisis. As addressed in Part 1, a key element of that success was the development of a culture of vigilant and proactive supervision following the collapse of HIH.

89. The success of this formula has been recognised by jurisdictions that experienced financial instability through the recent crisis. The Netherlands, for example, had moved to a 'twin peaks' model prior to the financial crisis, but have since sought to strengthen their regulatory system by changing the culture of their prudential regulator to be more forward looking and intensive.[29]

90. An important aspect of effective supervision is the independence of the regulators from government in implementing their supervisory functions. The importance of independence was emphasised in two substantial reviews:

- the Palmer Report into the role played by APRA in the collapse of HIH — which urged the government to provide APRA with a high degree of de facto independence and the ability to act quickly and decisively;[30] and
- the Uhrig Review of corporate governance of statutory authorities and office holders. The Uhrig Review concluded that the independence of regulators is important when functions require a separation from government to ensure objectivity.

91. However, independence of regulators needs to be balanced by appropriate accountability mechanisms. The Uhrig Review found that:

> *"The greater an organisation's independence, the greater is the need for robust governance mechanisms as a means of ensuring it is discharging its delegation appropriately.*
> *…*
> *Robust governance provides assurance, not only to government, but also to the Parliament and the public, that those in the community affected by the activities of an authority are protected from the inappropriate exercise of power."*[31]

[29] IMF, 2011
[30] Palmer, 2002, 138
[31] Uhrig Review, 2003, 18

92. Wallis recommended a range of mechanisms by which the actions of the regulators would be transparent and subject to scrutiny, including annual reporting to Parliament and monitoring of developments by a Financial Sector Advisory Council.

93. Such mechanisms improve transparency and provide a valuable vehicle for engaging with industry on developments in the financial system and its regulation.

94. However, there is room to improve these accountability mechanisms. Developing measures of success would assist regulators, industry and Parliament to identify some of the tensions within the regulators' statutory objectives (such as between stability and competition for APRA, and between lower business costs and informed investors for ASIC) and support transparent dialogue on how the regulators address these tensions.

95. The Uhrig Review recommended governments prepare and publish a statement of expectations for government agencies. The statement would outline the Government's broad policy framework related to each agency's role and responsibilities. The Review also recommended that each regulator reply with a statement of intent outlining how they intend to meet policy goals and performance indicators.

96. The Government has indicated in its commitment to promote regulatory certainty that it will issue new statements of expectations. The Productivity Commission to provide advice on a framework that will lead to specific indicators for assessing agency performance, including explicit metrics of success that take account of policy objectives and compliance costs.

Overlaps and gaps require attention

97. One of the main benefits of the Wallis reforms was to establish clear functional lines of responsibility for the specialist financial system regulators.

98. While the broad architecture established by Wallis remains sound and should be retained, it is timely for the Financial System Inquiry to address any overlaps or gaps between the roles of the regulators to ensure a clear demarcation between regulators is maintained.

99. To this end, a key issue for the Financial System Inquiry to consider is the blurring of responsibilities between APRA and ASIC that has occurred since the Wallis Inquiry.

100. Establishing the prudential perimeter and ensuring that investors, particularly retail investors, are clear on the risks they are expected to manage on each side of the prudential perimeter is challenging.

101. Wallis judged that prudential regulation should only apply in limited circumstances:

> *Governments should not seek to impose safety regulation across the entire financial system. […] Despite its importance, safety does not require that all financial promises be kept. Risk is an essential component of any financial system and, in an efficient system, is priced to reward those who bear it.*[32]

102. Wallis also took account of the systemic importance of institutions that offer financial promises in defining the prudential framework. For example, Wallis concluded that finance companies, such as those that issue debentures, need not be prudentially regulated given their relatively minor share of the market.

Consumers have difficulty identifying the prudential perimeter

103. In practice, the delineation of which institutions should be subject to prudential regulation by APRA can be difficult. While the 'intensity of promises' offers a framework for delineating the prudential/non-prudential boundary, a remaining challenge for users of the financial system (retail consumers and investors in particular[33]) is distinguishing promises that are intense from those that are not, and making a meaningful distinction between **regulation** by APRA and **registration** with ASIC.

104. The collapses of Trio Capital in 2009 and Banksia Securities Limited in 2012 have highlighted the challenges for investors in distinguishing between:

- Banksia, a debenture issuer, and an authorised deposit taking institution regulated by APRA that is covered by the depositor protection arrangements of the Financial Claims Scheme;
- self-managed super funds and APRA-regulated funds that are covered by the fraud compensation schemes under the *Superannuation Industry (Supervision) Act 1993*; and
- the regulatory environment monitored by ASIC which is focussed on conduct and disclosure versus the regulatory environment managed by APRA that protects depositors and superannuants through prudential regulation.

105. The previous government responded to the collapse of Banksia by requesting ASIC and APRA consult on proposals for strengthening the regulation of companies that issue debentures to retail investors.

[32] Wallis Inquiry, 1997, 175
[33] ABACUS, 2013

106. In responding to that request, ASIC consulted on proposals to introduce a quasi-prudential regime that would include capital and liquidity requirements, as well as enhanced disclosure and governance. These proposals are currently on-hold pending the outcomes of the Financial System Inquiry.

107. These proposals reflect a significant departure from the Wallis framework. Expanding ASIC's responsibilities to include quasi-prudential regulation would compromise a key element of the twin peaks framework being the concept that prudential regulation is oversighted by a single specialised regulator with the requisite skills and clear accountability.

108. Investors and other consumers of financial products are likely to believe mistakenly that entities subject to quasi-prudential regulation (which is rules-based) are also subject to active supervision – which is a feature of genuine prudential regulation.

109. The proposal to expand ASIC's responsibilities to include quasi-prudential regulation points to the challenges for investors — illustrated by Trio and Banksia — in understanding where the prudential perimeter is drawn and in understanding the risks that they bear and must manage on either side of that perimeter.

Redefining the prudential perimeter exacerbates the challenges

110. The distinction between those entities that are prudentially regulated and those that are not is a source of confusion among investors and invites regulatory arbitrage.

111. Wallis left open the possibility of revising the prudential perimeter to reflect market evolutions:

> *Over time, the scope and intensity of prudential regulation should be adjusted to take account of changes in the intensity of these risks in the different parts of the financial system.*[34]

112. However changes, particularly extensions, to the prudential perimeter carry costs:

- the direct costs of the regulation and its associated compliance burden;
- the opportunity cost associated with locking capital in low-risk assets (Australia already has a very high proportion of financial assets in prudentially regulated institutions, reflecting the dominance of banking and APRA-regulated funds); and
- adding to investor uncertainty over the extent and effect of prudential regulation.

[34] Wallis Inquiry, 1997, 20

113. The more appropriate response would be to retain the Wallis framework of a distinct prudential perimeter — intensively supervised and regulated by a specialist agency in APRA — while exploring the scope for improving the capacity of investors to distinguish between entities that are prudentially regulated and those that are not. The development of the Financial Claims Scheme 'seal' is a step in this direction.

114. Clearly this is not a trivial task, and it underlines the role for financial advisers in assisting unsophisticated investors to navigate the financial system and potential benefits of the new tools for consumer empowerment described in Part 1.

Part 3: Sectoral issues

Banking

Key points

115. The key banking issue before the Financial System Inquiry is the level of competition within the sector and the extent to which it can be increased to promote greater efficiency without adversely affecting the stability of the system.

116. The relationship between banking competition and stability is complex — the theoretical and empirical literature is divided on the nature of the relationship. However to the extent that appropriate regulation and an active supervisor guard against systemic risk, then competition in banking will drive efficiency gains.

117. Competition in banking cannot be characterised simply by market structure. The sector is clearly more concentrated than before the financial crisis, yet four parliamentary inquiries have reached no firm conclusions on the level of competition.

118. In part this reflects that many indicators suggest that competition in the sector is relatively robust — net interest margins are near thirty year lows and measures of consumer satisfaction are near record highs — albeit the level of competition varies in intensity across market segments and over time.

119. Nonetheless the concentrated structure of the banking sector leaves no room for complacency about its capacity to meet the future needs of the Australian economy.

120. The Financial System Inquiry should review the scope to increase the efficiency of the sector through regulatory reform to promote competition or to price government intervention in the sector that has the potential to introduce distortions in the allocation of capital. In particular, the Financial System Inquiry should address:

    - the pricing of the Financial Claims Scheme to ensure that the benefits of government support for depositors are appropriately priced;
    - the implied guarantee for banks considered too big to fail, recognising the emerging global response to this problem and being mindful of the costs of developing an idiosyncratic Australian response; and
    - the impact of the differential application of global banking prudential standards, balancing the impact on competition against the objective of ensuring that capital requirements imposed on banks are sensitive to the risk borne by those banks.

The banking sector is concentrated but reasonably competitive

121. The relationship between competition and stability in banking is complex and the theoretical and empirical literature is divided on the nature of the relationship. [35]

122. The traditional 'charter view' posits that competition generally has a negative impact on stability. Under this view, banks with market power operating in an uncompetitive market have an incentive to limit their risk-taking to protect their 'charter value' and enjoy higher returns.[36] Increased competition reduces this 'charter value' and promotes risk-taking.

123. An alternate view suggests that bank competition can instead improve stability. Competition assists stability by removing less efficient banks from the financial system, making the overall system more resilient, adaptive and efficient over time.[37]

124. In practice, the extent to which competition either reduces or improves stability is likely to be dependent on the regulatory framework in which banks operate. Competition in the banking sector will drive efficiency gains when appropriate regulation and an active supervisor are in place to guard against systemic risk.

The level of competition

125. The level of competition in the Australian banking system has been subject to much scrutiny, with four parliamentary inquiries on the issue since the global financial crisis.[38] While no firm conclusions were reached, a common theme from these inquiries was that greater competition would be beneficial.

126. The lack of a clear conclusion as to the state of competition in the banking sector reflects the inherent difficulties associated with assessing banking competition.

127. Market concentration is often cited as the key indicator of competition. The Australian banking system has become increasingly concentrated following the financial crisis, with the major banks' share of home lending rising from around 62 per cent pre-crisis to around 77 per cent in January 2014.[39]

[35] OECD, 2010
[36] Keeley, 1990
[37] Schaeck and Cihak 2013
[38] House of Representatives Standing Committee on Economics 2008; 2009; Senate Economics Committee 2009; 2010
[39] APRA Monthly Banking Statistics and RBA Financial Aggregates

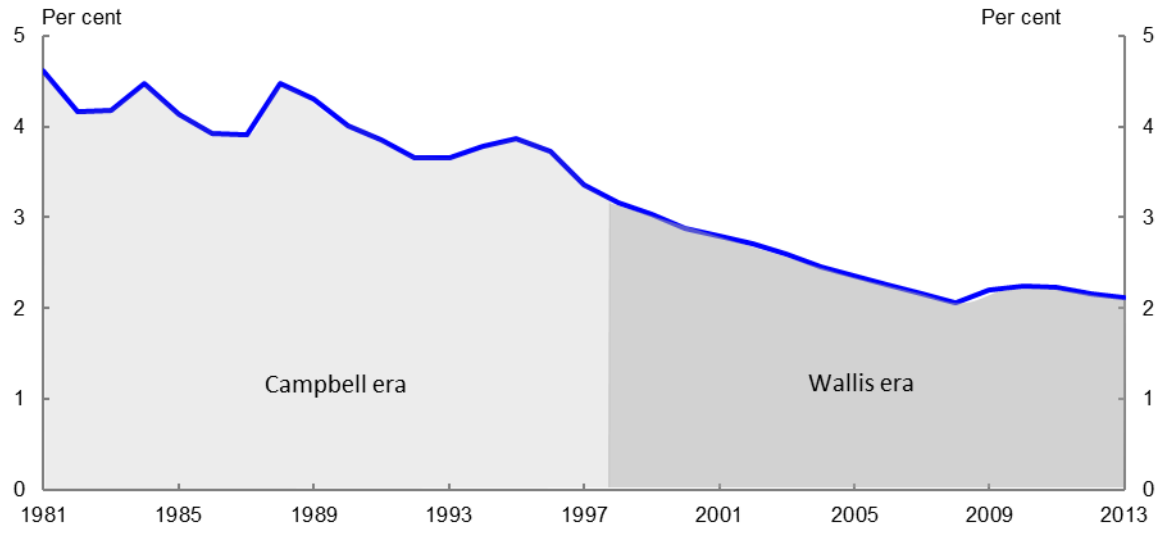
128. One of the drivers of the increase in concentration was turmoil in securitisation markets during the financial crisis. From the late 1990s the relative costs of securitisation fell, allowing smaller lenders to compete in mortgage markets with less reliance on balance sheets or capital bases to fund their loans. The cost of securitisation increased markedly during the financial crisis, leading to the exit of many non-bank lenders and the removal of an important source of competition.

129. However, concentration is not necessarily a good measure of competition.[40] For example, concentration may be a result of intense competition, with a small number of highly efficient firms pushing other less efficient firms out of businesses. Alternatively, concentration may be a result of regulatory barriers to entry, which reduce competition and allow firms to exert market power.

130. Further, there are significant economies of scale benefits in banking that tend to result in concentration in the banking sector. For instance, being large allows banks to diversify and pool their risks, grants significant network benefits and allows more resources to be devoted to regulatory compliance. Larger banks may also be perceived as 'too big to fail', allowing them to benefit from a lower cost of funds (see later).

131. Many indicators suggest that competition in the banking sector is relatively robust. For instance, bank's net interest margins have almost halved since the early 1990s and reached historic lows during the global financial crisis (see Chart 1).

Chart 1: Bank net interest margins



Source: RBA and bank financial reports.

[40] Claessens and Laeven 2003

132. Further, banks have been adopting technological innovations, such as core IT system upgrades and mobile banking, leading to an improved customer experience. More generally, banks appear to be competing on service, leading to improved customer satisfaction ratings, which are near record highs.[41]

133. The level of competition varies in market segments and across time. A clear example of a market in which the level of competition has changed over time is the deposit market.

134. Following the financial crisis, banks have responded to a change in the attitudes of investors, rating agencies and regulators towards the risks associated with wholesale funding by competing intensely for deposits, driving up the cost of deposits. For example, the cost of banks' bonus saving accounts has increased from around 185 basis points **below** the cash rate in 2007 to around 140 basis points **above** the cash rate in 2014.

Small business lending

135. While many indicators suggest that, overall, competition in the banking sector is relatively robust, it is not clear that competition is as strong in the small business lending market.

136. Small businesses are a vital part of the Australian economy, representing approximately 96 per cent of all businesses in Australia, and accounting for around 43 per cent of private sector employment.[42] As such, in assessing the performance of the financial system, the Inquiry should consider whether the banking system is meeting the needs of small business.

137. Although indicators suggest that small businesses do have access to finance — with 94 per cent of small business loan applications approved and a report co-authored by the Council of Small Business of Australia and the Australian Bankers' Association finding that only 5 per cent of small businesses expressed concerns about access to finance — the price of small business lending has increased relative to home loans and large business loans.[43]

138. While the higher cost of small business loans partly reflects their risk — the default rate on small business loans is around double that of non-business related residential mortgages — it may also be a reflection of a lack of competition in the small business lending market.

[41] Roy Morgan 2014.
[42] ABS cat.no. 8165.0 and 8155.0
[43] COSBOA, 2013.

139. Anecdotal evidence also suggests that many small businesses find the loan application process confusing, which may be preventing some small businesses from applying for loans.

No room for complacency

140. However the concentrated structure of the banking sector leaves no room for complacency as to its capacity to meet the needs of the Australian economy over coming decades. The Inquiry should consider whether there is scope to:

- increase the efficiency of the sector through regulatory reforms that promote competition; and
- price government guarantees in the sector that have the potential to distort the allocation of capital.

The Financial Claims Scheme is not properly priced

141. The Financial Claims Scheme (FCS) provides deposit insurance and was introduced in October 2008. The FCS applies up to a cap of $250,000 per account-holder, per bank. The FCS is designed to allow depositors to access their protected deposits quickly, without the need to wait for the liquidation process to be complete.

142. The FCS helps maintain financial stability by reducing the likelihood of bank runs by ensuring that depositors have timely access to their funds during a crisis. This also lowers the impact of bank failures by enabling depositors of a failed bank to continue to consume goods and services.

143. The FCS introduces a distortion as it limits depositor's incentives to monitor bank performance and risk-taking. However, the FCS is now a permanent feature of Australia's financial system and attempts to remove it are unlikely to be credible — depositors are likely to continue to act as though their deposits are insured by the Government. That said, there is scope to minimise this distortion and ensure that those who receive a benefit from the FCS pay for the benefit they derive.

The Financial Claims Scheme has the potential to create distortions

144. The FCS potentially distorts the Australian financial system by reducing depositors' incentive to monitor bank performance and encouraging individuals to invest in deposits over other assets such as retail corporate bonds. In practice though, the FCS is likely to reinforce rather than alter depositor's behaviour as depositors already acted as though the FCS was in place prior to its introduction.

145. Prior to the introduction of the FCS in 2006 — only 10 per cent of people surveyed were of the opinion that their deposit account was not guaranteed and that, in the event of a failure, the government was unlikely to step in.[44]

146. There are a number of other factors that reduce these moral hazard concerns by placing constraints on bank risk-taking, including:

- risk-based capital adequacy requirements, which require banks to hold additional capital when they take on more risk;
- APRA's proactive supervisory approach which also includes enhanced requirements for banks to have risk management systems in place to address material risks; and
- market discipline on bank behaviour provided by suppliers of bank wholesale funding, who are not covered by the scheme and still have an incentive to play a monitoring role.[45]

Funding the Financial Claims Scheme

147. Pricing guarantees such as the FCS can reduce potential distortions. However, in the case of a levy for the FCS, careful design is required since smaller banks are more reliant on deposits than the major banks and can be disproportionally impacted.

148. At present, the FCS is funded after the scheme has been triggered. That is, after a bank fails, the Government would levy all remaining banks to cover the costs. As such, those who benefit from the FCS — banks and depositors — do not pay for the benefit they enjoy. The planned introduction of an FCS levy would remedy this problem, reducing the distortions to the financial system.

149. There are three main methods available for calculating the size of the levy each bank should pay — a flat rate, a risk-based and a tiered approach. The 2013-14 MYEFO includes the financial claims scheme outlined in the 2013 Economic Statement, subject to the outcomes of the Financial System Inquiry.[46] That scheme was costed on the basis of an average levy of 5 basis points.

150. Under a flat rate, all banks are levied at the same rate. The amount they pay only reflects differences in the size of their assessable base. This approach would be consistent with the objective of making banks pay for the benefit they receive.

[44] RBA 2006.
[45] Davis 2011.
[46] 2013-14 MYEFO.

151. Alternatively, a risk-based approach could be used. Under a risk-based approach, the rate of the levy would vary between banks depending on an assessment of their riskiness. A risk-based approach could potentially address the moral hazard concerns associated with the FCS and discourage excessive risk-taking.

152. In forming a view as to which approach should be taken in Australia, the Financial System Inquiry should note that a risk-based approach:

- would be more complicated to administer;
- could send adverse signals to the market about the stability of individual banks. Although a risk-based approach was used to price the wholesale guarantee during the global financial crisis without sending adverse signals about the stability of individual banks, this problem could still arise in the future if a risk-based approach is utilised; and
- lessen competition, as smaller banks with lower credit ratings would be required to pay a higher fee.

153. Under a tiered approach, only banks with assets above a certain level would be required to pay the levy. The tiered approach would be beneficial for competition and would offset the tendency of either the flat and risk-based approaches to disproportionately affect smaller banks that are more reliant than larger banks on deposit funding.

'Too big to fail' is distorting the financial system

154. Australia's major banks are commonly considered to benefit from an implicit government guarantee of their financial viability reflecting the perception of investors, rating agencies and analysts that they are 'too big to fail'.

155. The perception is illustrated by the commentary of some of the credit rating agencies on the credit risk of the major banks. Standard and Poors recently stated that '*our issuer credit rating on ANZ is two notches higher…reflecting our view of a high likelihood of extraordinary government support in a crisis*'.[47] Similar comments are made on other major banks.

156. The perception that the major banks are too big to fail has two major consequences for the efficiency and stability of the financial system:

[47] Standard & Poors 2013.

- moral hazard: the behaviour of the major banks and their investors, particularly their attitude to risk and its management, may be affected as some downside risk is perceived to be shifted to the government.
- allocative inefficiency: mispricing of risk will reduce the efficiency of the financial system as the price signals for the allocation of capital are distorted. All else being equal, major banks funding costs will be lower relative to competing financial institutions, such as smaller banks or corporate bonds.

157. Appropriately, current policy settings respond to the problem of 'too big to fail' through the intensity of supervision by APRA and by requiring domestic systemically important banks to hold additional capital.

Bail-in

158. Part of the G20's policy response to the problem of 'too big to fail' is to reduce the moral hazard and fiscal costs through a bail-in regime, which includes a framework for loss absorbency. Bail-in involves allowing the Government to write down the value of bank debt or converting debt securities into equity when the bank fails.

159. In theory, a credible bail-in regime would directly address the moral hazard and efficiency issues caused by too big to fail. Whether the market would ensure appropriate discipline in practice is a matter yet to be tested.

160. The removal of the implicit guarantee would likely result in the major Australian banks credit ratings bring revised downwards to a level that more accurately reflects the risk of the institutions and — all else being equal — would increase Australia's overall funding costs. The increased funding costs are likely to be passed onto borrowers.

161. The credibility of a government's commitment to bail-in would be critical to its effectiveness in removing the pricing advantage brought about by the implicit guarantee.

162. However government support for failing banks overseas demonstrates how difficult it is for governments to not support a single large, and/or highly interconnected, failing bank, let alone in a more widespread financial distress situation. During crises there is considerable pressure on government to minimise the losses to shareholders and bondholders to prevent a shock to the broader financial system and economy.

163. Responding to such pressure, despite having previously committed to a bail-in policy, would raise the overall cost to the broader Australian community from any subsequent bail out. A bail-in policy would generate efficiency gains by ensuring that lenders rather than taxpayers met the cost arising from the failure of a bank to meet

its obligations, though appropriately the lenders would be compensated *ex ante* for their higher level of risk. However, any subsequent intervention by a government to take any materialised risk onto its own balance sheet to prevent a shock to the broader economy would involve a separate and additional cost for taxpayers.

164. Australia should consider its approach on this issue in light of international developments.

Alternative options

165. Another option to address the issue of too big to fail is to price the implicit guarantee through the imposition of a tax on the major banks. This would reduce their funding cost advantage over their competitors.

166. A tax that removes the inefficiencies created by the implicit guarantee would require careful pricing to achieve the desired behavioural response from investors. If the tax were set at an incorrect level, it risks creating new distortions. For instance, it may over-correct and disadvantage the banking system relative to the outcome where no implicit guarantee exists.

167. A tax would have the benefit of providing the Government with additional funds in the unlikely event that it was required to support a failing bank.

168. However, Australia would be choosing to introduce a regime that differs from the work of the Financial Stability Board at a time when G20 members are harmonising financial regulation to facilitate cross border capital flows while minimising the risk of regulatory arbitrage.

169. As the design of bail-in, including loss absorbency, remains a work in progress, Australia should not introduce an idiosyncratic policy response while the global regulatory architecture remains to be settled.

170. Another alternative would be for the Australian government to seek to 'level the playing field' by offering an explicit guarantee to all banks, large and small. However:

- this would simply introduce new distortions — such a guarantee would favour banks over non-bank channels of finance (such as corporate bonds);
- would need to be priced to reflect risk. This is difficult to do in practice and may not benefit competition as some banks would inevitably pay a higher fee; and
- would exacerbate the banking sector's incentive to take risk by limiting their losses while adding a large contingent liability to the government's balance sheet.

Bank's capital requirements need to reflect risk

171. Bank's hold capital to absorb losses. To ensure that banks can continue to operate through period of stress, the level of capital that banks are required to hold varies with the riskiness of their assets. Having capital requirements that reflect risk is one of the key aspects of Australia's prudential framework.

172. There are two approaches to calculating regulatory capital requirements — the standardised and internal ratings based approaches. In Australia, the major banks use the internal ratings based approach while smaller lenders currently use the standardised approach.

173. Under both approaches, bank's total minimum regulatory capital requirements are set as a fixed proportion of their risk weighted assets, which is the sum of assets owned by the bank multiplied by their respective risk weights.

174. Riskier assets have higher risk weights, so additional capital must be held when a bank takes more risk. For example, under the standardised approach, a standard mortgage with a loan to value ratio under 60 per cent receives a risk weight of 35 per cent, while unsecured personal loans have a risk weight of 100 per cent.

175. The difference between the standardised and internal ratings based approaches lies in the way these risk weights are determined:

    - under the standardised approach the risk weights are set by APRA; and
    - under the internal ratings based approach risk weights are calculated by individual banks using their own internal credit assessment models (which must be approved by APRA).

176. The internal ratings based approach results in risk weights that are more sensitive to risk. Under the standardised approach, the risk weight on a mortgage does not vary by purpose, while under the internal ratings based approach, mortgages with different purposes (such as those to finance a business) may receive higher risk weights, reflecting their increased risk.

177. In order to be eligible to use the internal ratings based approach banks must satisfy APRA that they have sufficiently robust internal risk management systems and data. Achieving this level of sophistication requires significant investment by a bank.

178. As banks using the internal ratings based approach tend to be larger and more diversified than banks utilising the standardised approach, the risk weights generated by the internal approach tend to be lower than those set by APRA under the standardised approach. This effectively lowers the funding costs of those banks using

the internal ratings based approach, boosting their scale advantage and putting them at a competitive advantage over other banks.

179. While internal rating based banks may hold lower levels of capital for a given amount of assets, they are also subject to higher costs associated with the requirement to have more sophisticated risk management systems.

180. The Inquiry should explore the extent to which the internal ratings based approach stifles competition in the banking sector by lowering the major bank's capital requirements relative to banks using the standardised approach. However, when forming this view, the Inquiry should note that:

- the internal ratings based approach results in capital requirements that better reflect risk, improving the allocation of capital;
- changing the risk weights in the standardised approach could result in standardised banks no longer being compatible with global regulatory standards, which could impact their capacity to access global capital markets. This is unlikely to be an issue for smaller lenders who rely solely on domestic funding; and
- the internal ratings based approach provides banks with a strong incentive to upgrade their risk management systems, which benefits financial stability.

Superannuation

Key points

181. Superannuation is fundamental to Australia's three tier retirement income system which comprises a pension safety net, compulsory superannuation and incentives for additional voluntary saving. An important issue before the Financial System Inquiry is the capacity of the superannuation sector—in conjunction with or in competition to the insurance sector—to meet the needs of Australians in retirement.

182. Superannuation policy has substantially boosted the size of funds managed by the superannuation sector and changed the flow of funds through Australia's financial system. This is the direct result of policies designed to address biases against long term savings: compulsory contributions under the Superannuation Guarantee and tax concessions that mean that superannuation is the most lightly taxed form of savings. The Taxation White Paper provides an opportunity to consider the extent to which these arrangements (and the Age Pension) generate adequate retirement incomes as the sector matures.

183. The focus for the Financial System Inquiry should be on the efficiency of the superannuation sector in managing the funds generated by those policy settings. The size and centrality of the superannuation sector within Australia's financial system—and the ageing of Australia's population—mean that the allocative, technical and dynamic efficiency of the superannuation sector are central to the work of the Inquiry.

184. Assessing the allocative efficiency of the superannuation sector is a difficult task given the variety of preferences of individual members and the complexity of the taxation and regulatory arrangements affecting the asset allocation decisions of funds. The allocative efficiency of the sector cannot be assessed by a single metric such as the proportion of funds invested in equities.

185. One approach to assessing the efficiency of asset allocations within the sector would be to review the structure of the sector and assess whether there are any barriers or impediments to an efficient allocation of capital. Superannuation trustees allocate funds within a highly contested investment market.

186. In the absence of any barriers or impediments to their efficient allocation of capital, it is important that trustees should continue to act in the best interest of their members rather than any perceived 'national interest'.

187. The relatively high cost of Australia's superannuation sector suggests there is scope for the sector to continue to improve its technical efficiency — reducing the use of

resources internal to the sector — to place downward pressure on fees. Recent policy reforms, when fully implemented, combined with the continued expansion of choice and higher levels of competition within the sector should drive improved efficiency across the sector.

188. The recent policy reforms were designed to provide cost effective superannuation arrangements for those members with limited engagement with their retirement income arrangements, while allowing more active individuals to manage their own arrangements. However, many of these reforms have focussed on the accumulation phase, and it would be timely for the Financial System Inquiry to review the availability and adequacy of options for the retirement phase (in conjunction with the Government's upcoming review of regulatory barriers restricting the development of income stream products).

189. Australia's superannuation sector needs to continue to improve its dynamic efficiency—its ability to innovate and provide products and services valued by consumers, particularly in response to the expanding needs of Australians in retirement. The superannuation sector is focussed on supporting saving through the accumulation phase, but neither it nor the insurance sector has sufficiently developed the range of products necessary for individuals to manage their financial affairs through retirement.

190. The Financial System Inquiry should review the availability of alternative retirement income products, the range of products that balance risk transfer and affordability and identify any industry, taxation or regulatory impediments to developing cost-effective products that enable individuals to manage longevity risk, taking into account the proposed Government review of regulatory barriers currently restricting the availability of income stream products. The Inquiry should also consider the appropriate role for public policy, if any, in managing the systemic element of longevity risk that cannot be diversified across individuals in the same age cohort.

191. Self-managed superannuation funds allow individuals greater choice and control in managing their own retirement income arrangements, and the growth in self-managed superannuation funds provides competition to the APRA-regulated funds that will further drive technical and dynamic efficiency gains in the sector. Self-managed superannuation funds involve no financial promise and are not prudentially regulated. As such, they are appropriately subject to a light touch compliance regime administered by the Australian Taxation Office. This approach should be maintained.

Superannuation is fundamental to Australia's retirement income policy

192. Superannuation, both the compulsory contribution element and concessional taxation, is fundamental to Australia's retirement income policy. An important issue before the Financial System Inquiry is the capacity of the superannuation sector—in conjunction with or in competition to the insurance sector—to meet the needs of Australians in retirement.

193. Superannuation contributes to two of the three elements in Australia's provision of retirement incomes, with the three elements being:

- the means-tested and publicly funded Age Pension;
- compulsory private savings through the Superannuation Guarantee arrangements; and
- incentives for voluntary savings.

194. The compulsory contribution and tax concession elements of superannuation are deliberate policy decisions taken to address biases against long-term savings within the Australian economy. Correcting these biases needs to be balanced against the creation of other potential distortions for the flow of funds through the financial system.

195. Compulsory contributions to superannuation are intended to address under-saving by individuals due to myopia—people not saving adequately for retirement because it is too far into their future.[48] The notion of mandated savings for retirement has been common throughout the developed world for many decades. However, in more recent times an alternative to compulsion to address long-term under-saving has been adopted in the United Kingdom and New Zealand, namely, automatic enrolment in superannuation but with the ability to opt out.

196. The concessional taxation of superannuation is also intended to address the bias in the current taxation system against long-term saving. The 2009 Australia's Future Tax System Review (AFTS Review) noted that the effective tax rate on earnings from savings increases the longer an asset is held. As superannuation saving is generally

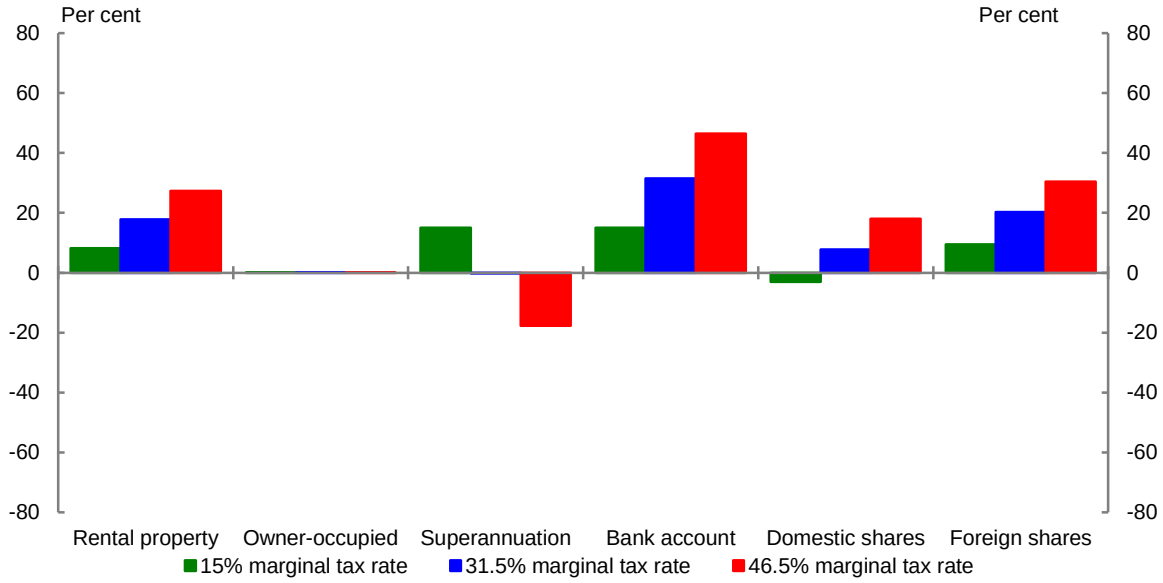
[48] AFTS Review, 2009

held for a longer time than other forms of savings, more favourable tax treatment is justified.[49]

197. Taxing superannuation at concessional rates also seeks to treat income as if it had been spread over an individual's entire life rather than just their working life. As a person's retirement income is generally lower than their income while working, a lower rate of tax on retirement income is justified.

198. The concessional taxation of superannuation flows is unusual in contrast to other savings vehicles because the effective marginal tax rate is lowest for those on the highest marginal income tax rate (see Chart 2). The concessional taxation treatment has supported strong growth in the superannuation sector. In 2010-11, voluntary contributions comprised around 60 per cent of total superannuation contributions, with the remainder due to Superannuation Guarantee contributions.[50]

Chart 2: Effective marginal tax rates for alternative savings vehicles



Source: AFTS Review, p67.

199. The effectiveness of compulsory contributions and the concessional taxation of superannuation in achieving adequate retirement incomes were considered in the AFTS Review.[51] The Taxation White Paper provides an opportunity to consider the extent to which existing arrangements, and the age pension, generate adequate retirement incomes as the superannuation sector matures.

[49] AFTS Review, 2009
[50] Treasury estimate based on ABS cat.no.5673 and APRA Statistics Annual Superannuation Bulletin.
[51] AFTS Review, 2009

200. Views on the overall adequacy of retirement income, including that sourced from the superannuation elements, will drive future change in retirement income policy. Any changes to superannuation settings would have implications for the financial system more generally.

201. The objective of superannuation policy to support retirement income needs to be balanced against the impact on present day consumption. This is especially relevant for low income individuals whose increased retirement savings will more likely come at the cost of present day consumption.

The superannuation sector has ballooned since Wallis

202. The superannuation sector is made up of corporate, public sector, industry, retail and self-managed superannuation funds.

203. The relative importance of the superannuation sector in the financial system has increased significantly since the Wallis Inquiry in 1997. Superannuation assets amounted to around 48 per cent of GDP ($321 billion) in 1997. As at December 2013, they are equivalent to 116 per cent of GDP ($1.8 trillion).[52]

204. Superannuation now accounts for the largest portion of household financial assets, around 49 per cent in 2011-12. [53]

205. There have also been significant shifts within the superannuation sector, with strong growth in the proportion of superannuation assets held by self-managed superannuation funds in recent years. The self-managed superannuation fund sector is now the largest by value, having increased its holdings of superannuation assets to around 31 per cent as at June 2013[54] from around 11 per cent in 1997. [55] In 2010-11, around 5 per cent of individuals who made superannuation contributions contributed to a self-managed superannuation fund. [56]

206. The superannuation sector will continue to grow as the impact of the Superannuation Guarantee policy accumulates and as the compulsory contribution rate increases to 12

[52] APRA, 2014, Statistics Annual Superannuation Bulletin
[53] ABS, 2011-12 Cat. 6554.0
[54] APRA Quarterly Superannuation Performance, December 2013
[55] APRA Insight, Issue 2 2007 (Special Edition)
[56] Treasury analysis of ATO 2010-11 confidentialised sample file of Member Contribution Statements. The data include all individuals with superannuation contributions in 2010-11. A small group of people have superannuation contributions to both SMSF and APRA-regulated accounts. These people are classified with SMSFs.

per cent. By 2040 superannuation assets are projected to reach 150 per cent of GDP ($8.4 trillion).[57]

207. The size and centrality of the superannuation sector within Australia's financial system—and the ageing of Australia's population—means that the allocative, technical and dynamic efficiency of the sector are central to the work of the Inquiry.

The superannuation sector is broadly conducive to the efficient allocation of investments

208. Superannuation funds generally operate within a trust structure, making the allocation of superannuation assets ultimately the responsibility of fund trustees.

209. Each trustee has a fiduciary obligation to act in the best interests of fund members which involves taking ultimate responsibility for the entity, and an obligation to manage the assets of the entity with competence, diligence, prudence and honesty.

210. In meeting their obligations, trustees will generally ensure that expert managers with specialist skills are advising and reviewing asset allocation decisions over time. This practice reduces asymmetric information and promotes a high level of financial literacy among decision makers.

211. Importantly, the obligations placed on trustees do not preference any particular asset class. Trustees have a duty to formulate and enact an investment strategy that gives consideration to, among other things, appropriate diversification, expected cash-flow requirements and the liquidity of the investments, subject to the risk and return preferences of their members.

212. The introduction of the 'Choice-of-Fund' legislation in 2005, consolidation among superannuation funds, the publication of superannuation fund league tables and the highly contested market for the provision of services to superannuation funds, all place competitive pressure on trustees to maximise returns for members subject to a given level of risk.

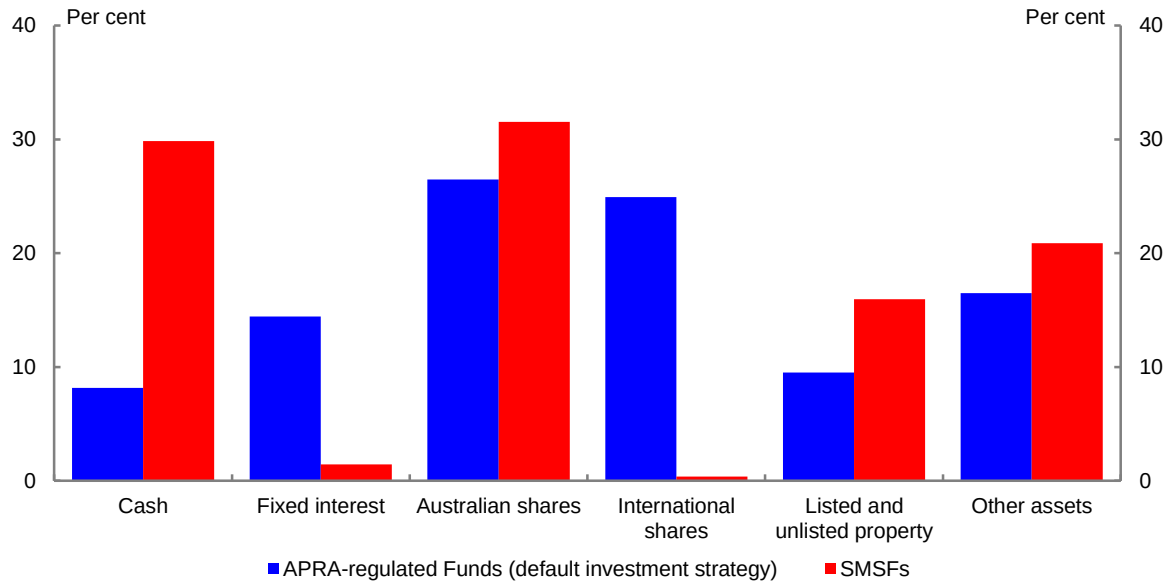
213. Questions have been raised about the share of superannuation funds allocated to equities — 51 per cent by APRA-regulated funds[58] and 32 per cent for self-managed

[57] Treasury projections using the RIMGROUP model. Current superannuation policies are incorporated including the increase in the Superannuation Guarantee to 12%. A steady (after fees) return for superannuation funds of around 6% is assumed. The asset value from the model is in nominal dollars (2040 prices) and is converted to a proportion of GDP using Treasury projections of GDP.

[58] APRA, Annual Superannuation Bulletin, June 2013. Note: This figure only represents the share of investments held in default investment strategies.

superannuation funds[59] as at 30 June 2013 (see Chart 3). There are sensible reasons to support the Australian system currently having a higher proportion of equity investments — such as the distribution of members who are in the accumulation phase, and the defined contribution nature of our system. However, compared to many overseas pension systems these proportions are high. Given the volatility of share returns, the weighting of funds' investment portfolios towards equities potentially exposes individuals to increased risk, particularly when they are nearing their retirement drawdown phase. The sector is responding to these concerns by developing 'life-cycle' products that alter members' asset allocation over their life time.

Chart 3: Asset Allocation Comparison of self-managed superannuation funds and default investment strategy for APRA-regulated funds, 30 June 2013



Source: APRA Annual Superannuation Bulletin June 2013 and ATO Self-managed super fund statistical report December 2013.

Note: The cash category also includes term deposits.

214. Questions have also been raised about the relatively large allocation by self-managed superannuation funds to cash (30 per cent) and relatively small allocation to international shares (less than 1 per cent). The high allocation towards cash may reflect the age distribution of self-managed superannuation fund members, with more members close to or in retirement. The small allocation to foreign assets may reflect risk-return preferences. However, these allocations could also reflect market barriers that prevent self-managed superannuation fund trustees from adopting more diversified portfolios or factors favouring a particular asset class (including the tax

[59] ATO Self-managed super fund statistical report, December 2013

system as touched on in paragraph 216). Potential barriers include the increased search costs, particularly for overseas investments, and complexity associated with more diversified portfolios.

215. There are many factors within the financial system and broader economy, but outside the superannuation sector, that can influence rates of return and risks for assets—for example, the structure of the taxation system. There is a wide dispersion of individual members, all with different preferences, and what might be considered efficient for a median member may not suit a specific individual. In addition, there is a complex interaction between taxation and regulatory arrangements that can affect the asset allocation decisions of funds.

216. A key, but complex example of the effect of the tax system on asset allocation by superannuation funds is the dividend imputation system. At one level, the availability of imputation credits appears to make the taxation treatment of investment income from Australian shares broadly neutral relative to income from other domestic assets such as bonds, but preferenced over foreign equities. However, when viewed in the context of genuinely open capital flows and the return on capital being set on global markets, the availability of imputation credits (also noting their refundibility) makes investment in Australian companies, at least in theory, even more favourable. But noting the complexity of the tax systems' treatment of debt, equity and various hybrid instruments, together with the different treatment depending on whether the instrument is domestically or foreign sourced, real world effects of dividend imputation are extremely difficult to ascertain. Accordingly, this issue is more appropriately left for consideration in the broader context of the Taxation White Paper.

217. The complex interactions within the financial system suggest the allocative efficiency of the superannuation sector cannot be assessed using a single metric, such as the proportion of funds invested in domestic equities.

218. One approach to assessing the efficiency of asset allocations within the sector would be to review the structure of the sector and assess whether there are any barriers or impediments to an efficient allocation of capital—a negative test.

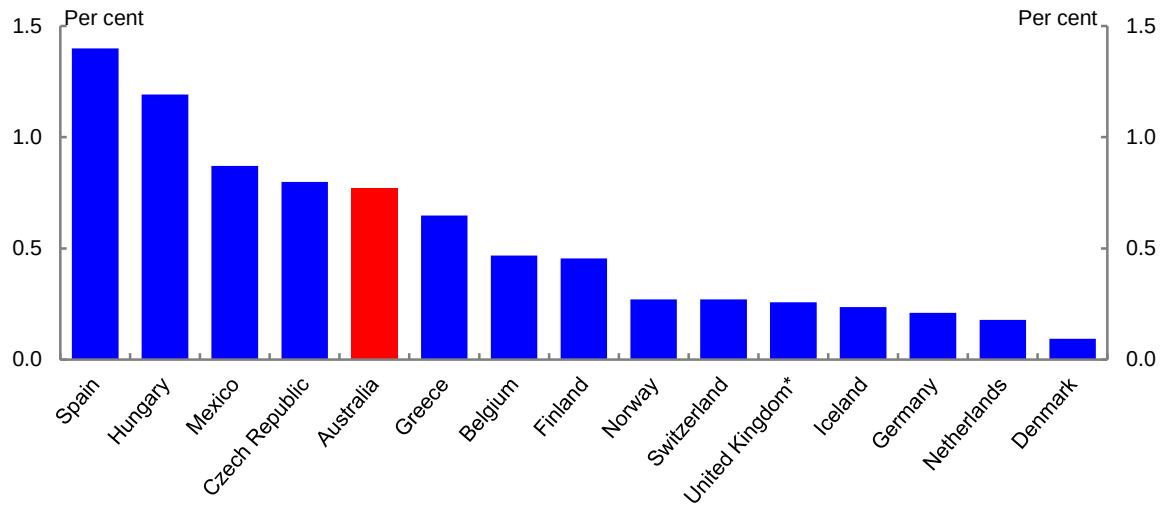
219. This approach suggests that the superannuation sector is broadly conducive to the efficient allocation of investment, primarily because superannuation trustees allocate funds within a highly contested investment market.

220. In the absence of any compelling evidence to suggest substantial inefficiency in the allocation of capital within the superannuation sector, trustees should continue to act in the best interests of their members rather than any perceived 'national interest'.

Scope for the superannuation sector to improve technical efficiency

221. The relatively high cost of Australia's superannuation sector (see Chart 4) suggests there is scope for the sector to continue to improve its technical efficiency — reducing the use of resources internal to the sector — to place downward pressure on fees.

Chart 4: Pension funds' operating expenses as a share of total investments (selected OECD economies, 2012)



*UK data is for 2011.
Note: There can be differences in what is covered in the definition of 'operating expenses'. As such, caution should be used when comparing countries using these OECD data, and also in any comparison with other studies.
Source: OECD Pension Markets in Focus 2013 and OECD Global Pension Statistics database.

222. There is a wide dispersion of fees across the superannuation sector. By segment, fees range from around 0.8 per cent to around 2.4 per cent of mean fund size.[60] Despite fees drifting down slightly as a share of mean fund size slightly since 2002, industry, public sector and corporate superannuation funds still have fees between around 0.8 and 1.1 per cent of mean fund size.[61] For example, on a $50,000 balance, the average superannuation fund in 2013 charged $726 in fees.[62]

223. Continued consolidation of APRA-regulated funds will enable funds to take advantage of economies of scale and reduce operating costs.[63] Since the Wallis Inquiry there has

[60] Rice Warner, 2012
[61] Rice Warner, 2012
[62] SuperRatings, 2014
[63] Cummings, 2012

been a significant consolidation of APRA-regulated funds. As at June 1997, there were over 4,700 APRA-regulated funds with more than four members[64], but by June 2013, this number had dropped to around 325 funds.[65] Thus far the smaller number of funds has been sufficient to ensure competition, with the largest fund comprising only around 6.2 per cent of total assets of APRA-regulated funds with more than four members. [66]

224. Principal-agent theory also suggests that the separation of the ownership of funds from those who manage the funds opens up the risk that managers rationally maximise their own interests at the expense of fund members. These risks rise when there is a potentially complex decision to be made, with possible asymmetric information and disengaged members.

225. Other reasons why Australia's superannuation sector may have high costs include the reliance on manual and paper-based back office systems and the maintenance of legacy systems.

226. Recent policy reforms, when fully implemented, combined with the continued expansion of choice within the sector will drive improved efficiency. Many of the policy changes strengthen the onus on trustees to manage funds in the best interests of members and provide more digestible information to members.

- The introduction of a cost effective default superannuation product (MySuper), aims, when fully implemented to simplify default superannuation products, constrain fees and charges, and improve their transparency and comparability.
- The SuperStream reforms, when fully implemented, are designed to make the processing of everyday superannuation transactions faster, easier and simpler by requiring superannuation funds and employers to use common standards for making and receiving rollovers and contributions.
- Giving APRA greater flexibility to oversee the sector, including the ability to issue prudential standards.
- Heightening the obligations of superannuation fund trustees and individual directors to manage their fund's superannuation assets prudently and in the best interests of all the members of the fund.

[64] APRA, Insight Issue 2, 2007
[65] APRA Quarterly Superannuation Performance, December 2013
[66] APRA Quarterly Superannuation Performance December 2013 and APRA Superannuation Fund-level Profiles and Financial Performance June 2013

- More detailed and better quality superannuation statistics to allow performance, fee and asset allocation comparisons.
- The introduction of product dashboards to assist consumers to more easily compare superannuation products.

227. Many of the recent reforms have focussed on the accumulation phase of the superannuation sector, and it would be timely for the Financial System Inquiry to review the availability and adequacy of default options for the retirement phase.

Scope for the superannuation sector to improve dynamic efficiency

228. It is clear that Australia's superannuation sector needs to continue to improve its dynamic efficiency—its ability to innovate and provide products and services valued by consumers—particularly in response to the expanding needs of Australians in retirement.

229. The superannuation sector is largely focussed on supporting saving through the accumulation phase, but neither it nor the insurance sector has sufficiently developed a broad range of products for individuals to manage their financial affairs through retirement.

230. Recent product development by APRA-regulated funds in response to the growth of self-managed superannuation funds does indicate a degree of dynamic efficiency within the superannuation sector, but more could be done.

231. The dominant retirement income product offered through Australia's superannuation sector is currently an account based pension—essentially a managed investment with a minimum annual drawdown required by regulation. In 2013, annuities captured only $2.2 billion of the $70 billion in funds accessible to Australians retiring.[67]

232. Account based pensions, as currently structured, do not protect against longevity risks. There are two types of longevity risk—idiosyncratic and systemic risk.

- The idiosyncratic element refers to the uncertainty, at retirement, around an individual's future lifespan. If a retiree does not know how long they will live, it is impossible for them to manage the drawdown of their pension to ensure a reasonably smooth retirement income. Too quick a drawdown will result in an individual relying on public pension programs

[67] Cumbo, 2014

or other resources. Too slow a drawdown could result in a lower standard of living in retirement than necessary.

- The systemic, or non-diversifiable, element refers to the uncertainty around the average lifespan of the current cohort of retirees.

233. Products that guarantee income over time regardless for how long an individual lives (often called lifetime annuities) are a means of eliminating both the idiosyncratic and systemic elements of longevity risk, but the range of products offered in Australia is narrow, and their take-up modest. The size of the individual immediate annuity market in Australia is very small, at 0.32 per cent of GDP, compared to other OECD nations, although comparison between countries may not be perfectly accurate because of definitional differences. In the United States the annuity market is valued at 15.4 per cent of GDP, and in Japan it is valued at 28.8 per cent of GDP.[68] This is an issue that both the AFTS Review and the Cooper Review canvassed.

234. Currently products that guarantee income for life or periods exceeding 10 years can only be offered by life insurers and friendly societies. But, other products that do not guarantee a specific income but still pool risk across individuals could be developed outside the life insurance sector.

235. The price of guaranteed income products may appear unattractive to consumers as product issuers need to hold a sufficient level of capital to support the guarantee and achieve an acceptable rate of return on that capital. 'Australia is the only country which relies predominantly on a mandatory privately administered defined-contribution structure for retirement income not to have incentives or mandates in place for longevity insurance.'[69]

236. The Financial System Inquiry should explore the scope for the sector to generate alternative retirement income products that offer individuals more choice in the trade-off between risk transfer and affordability.

237. In doing this, the Inquiry should identify any industry, taxation or regulatory impediments to developing cost-effective products, taking into account the proposed Government review of regulatory barriers currently restricting the availability of income stream products. For example, the Inquiry could consider where the regulatory line should be drawn between products that can only be offered within the life insurance framework and those that can be offered by others. The Inquiry could

[68] OECD, 2013

[69] Bateman and Piggott, 2010

also examine any regulations within the pension system that impact on the provision of income stream products, given the important interactions between the three elements of the retirement income system.

238. The Inquiry should also consider the appropriate role for public policy, if any, in managing the systemic element of longevity risk that cannot be diversified across individuals in the same age cohort.

Self-managed superannuation funds support consumer choice and should not be prudentially regulated

239. One of the noticeable changes to the financial system in recent years has been the growth of the self-managed superannuation fund sector to hold over $500 billion, or around one-third, of total superannuation assets.

240. By definition, these funds are self-managed by trustees who are also the members.[70] They have fewer than five members, who are usually trustees or directors of a corporate trustee. This limit is intended to ensure that the fund is sufficiently small to enable its members to be involved in its decision making and thus in a position to protect their own interests.

241. Wallis recommended that these funds should not be subject to prudential regulation, as there is no financial promise, intense or otherwise, made by trustees to separate fund members. As fund activities are conducted entirely at the risk of the beneficiaries, there should be no regulatory assurance attaching to them. Unlike APRA-regulated funds, self-managed superannuation funds do not have access to compensation mechanisms available to APRA-regulated funds if fraudulent conduct or theft results in financial loss.

242. The only administrative obligations of self-managed superannuation funds are to lodge a single annual return with the Australian Taxation Office, pay an annual supervisory levy and arrange an annual audit by an approved auditor. The audit requirement is the key compliance mechanism for self-managed funds.

243. This differs from APRA's approach, which promotes financial stability by requiring the institutions it regulates to manage risk prudently to minimise the likelihood of financial losses to fund members. Among other things, APRA will require trustees to maintain a risk-management framework and to notify them when the trustee

[70] Except in unusual circumstances, such as legal incapacity and sole member self-managed superannuation funds.

becomes aware of a significant breach of the framework or discovers that the framework does not adequately address a material risk. [71]

244. A strong appeal of self-managed funds is that they allow individuals the opportunity and freedom to engage more closely with their retirement savings. Continuation of the light-touch compliance framework allows individuals to take greater responsibility over their decisions without being subject to the requirements of the prudential regulatory framework. This position should be maintained.

245. Compliance oversight of self-managed funds should continue to reside with the ATO to ensure self-managed funds comply with all the relevant provisions of the tax law.

[71] Prudential Standard CPS 220 which commences from 1 January 2015

Insurance

Key Points

247. The Australian insurance sector includes two broad categories—life insurance and general insurance. The evolution of Australia's life insurance sector, which provides a means to manage death, disability and longevity risk, has been heavily influenced by the design of Australia's income support system and, in particular, the retirement income system.

248. Challenging business conditions for certain life insurance sectors—group life, total and permanent disability and income protection — are being addressed by industry and APRA, suggesting the regulatory framework is working well.

249. Nonetheless the range of retirement income products offered by the life insurance sector in Australia is narrow, and their take-up modest. The Financial System Inquiry should explore the scope for the life insurance sector to generate alternative retirement income products that offer individuals more choice in the trade-off between risk transfer and affordability.

250. There is a welcome trend for the pricing of general insurance policies to increasingly reflect idiosyncratic risks. This trend is being driven by insurance firms investing in better information around the impact of natural disasters and advances in technology and data management that allow firms lower cost methods of matching risk to customers.

251. More precise individual pricing of general insurance risk promotes the efficient allocation of capital and risk in the economy, but it also raises issues of affordability for some groups, geographical areas and types of insurance.

252. However these affordability issues should not be addressed by subsidising insurance premiums, other than in exceptional circumstances, as this would mute the price signals associated with such risk leading to an inefficient allocation of resources. Action by individuals and government to mitigate risk is the more efficient means of addressing affordability.

253. Competition also offers scope for addressing affordability. While there is no need for fundamental reforms to the regulatory architecture for the insurance sector, the Financial System Inquiry could explore improvements at the margin to foster greater competition through assessing barriers to overseas entrants and more effective price transparency for customers.

Australia's life insurance sector is heavily influenced by the design of income support systems

254. The evolution of Australia's life insurance sector, which provides a means to manage death, disability and longevity risk, has been heavily influenced by the design of Australia's income support system and, in particular, the retirement income system.

255. Most Australians save for their retirement through the superannuation sector. Australia also has a variety of publically supported insurance and income schemes that reduce the need for individuals to take out private income protection and disability insurance—for example, workers compensation schemes, compulsory third party motor insurance and disability income support mechanisms. In addition, large numbers of Australians who do have some form of life insurance product source this insurance through their superannuation fund.

256. Products that guarantee income over time are a means of mitigating against the idiosyncratic element of longevity risk, but the range of products offered in Australia is narrow, and their take-up modest. This is an issue that both the Henry Review and the Cooper Review canvassed.

257. Currently products that guarantee income for life or periods exceeding 10 years can only be offered by life insurers and friendly societies. The Financial System Inquiry should explore the scope for the life insurance sector to generate alternative retirement income products that offer individuals more choice in the trade-off between risk transfer and affordability.

258. In doing this, the Inquiry should consider where the regulatory line should be drawn between products that can only be offered within the life insurance framework and those that can be offered by others, such as companies in the superannuation, wealth management or general insurance sectors.

Challenging business conditions for some life insurance sectors are being addressed

259. The recent poor performance of some life insurers has attracted increased scrutiny from investors and the regulator.

260. Competitive pressures in the group life insurance market have driven lower pricing and the expansion in automatic acceptance limits—for example, accepting policyholders for higher amounts insured without requiring medical assessments.

261. A parallel development has been deteriorating claims experience for certain life insurance business lines, including in group life cover.[72]

- The sector reports that claimants, including those who may have been rejected by state government workers' compensation regimes with increasingly tighter claims criteria, are seeking claims through group life policies.
- Mental health related disability claims are rising sharply, perhaps reflecting a greater community acceptance and diagnosis of such conditions.
- In addition, policy lapse rates (where policyholders fail to renew) are rising, potentially reflecting consumer attitudes to risk as they age and the commission-based sales structure of the sector.

262. These developments have led to losses for some life insurers and reinsurers, causing some reinsurers to withdraw from the affected markets, raising concerns about the sustainability of current business practice, especially pricing and risk provisioning.

263. Indications are that market pressures and active supervision by APRA, within the existing regulatory structure, will shift industry practices, especially in terms of pricing and automatic acceptances. The extent to which there are underlying causes that cannot be addressed within existing frameworks should be considered by the Financial System Inquiry.

Pricing of general insurance products increasingly reflects idiosyncratic risks

264. The purpose of general insurance is to allow Australian businesses and households to manage a wide variety of risks including motor vehicle, public indemnity, professional indemnity, commercial and residential property and travel.

265. The series of natural disasters across Australia in recent years has resulted in insured losses running into the billions of dollars. Total insured losses from natural disasters from 2007 to 2013 averaged $1.9 billion a year, compared to $290 million a year from 2000 to 2006. The insured losses of the Queensland floods of 2010-11 and Cyclone Yasi in 2011 are together estimated to have totalled around $3.8 billion.[73]

266. Insurers have responded by investing in their understanding of the risk of, and therefore potential losses from, natural disasters. Advances in technology and

[72] APRA, Insight Issue 3, 2012
[73] Insurance Council of Australia, 2013

increased investment have provided insurers with greater access to better quality data, not just in relation to flood risk.

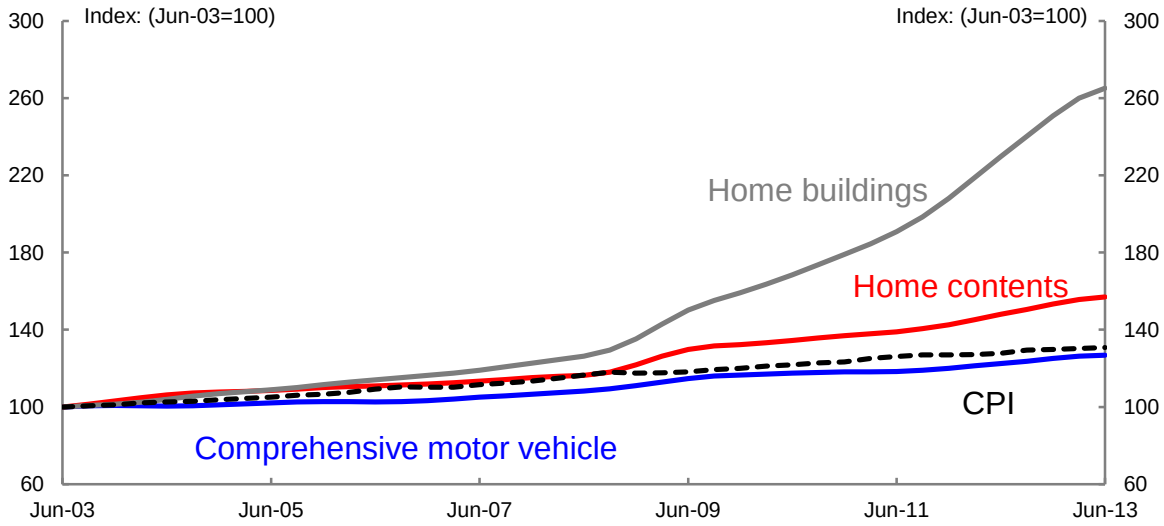
267. Advances in technology and data management have also allowed more precise measurement of idiosyncratic risks in other markets. Telematics, for example, allow assessment of an individual's driving skills and characteristics, enabling insurers to more precisely assess their level of risk of accident, and price their product accordingly. This also has the advantage of promoting good driving behaviour by the individual.

268. As a general principle, charging insurance premiums commensurate with the insurable risk is fair, equitable and allows for the efficient allocation of risk and capital. Exceptions to this principle sometimes arise. If the cost of individual risk becomes prohibitive and mitigation is not always possible, negative economic or social outcomes can result, which may justify a different approach (for example, the community rating of private health insurance effectively spreads the cost of higher individual health risks amongst policy holders, and risk equalisation distributes this risk equally amongst insurers). In the absence of such special considerations, charging on any basis other than idiosyncratic risk means that the cost will be inequitably and inefficiently shifted from those at greater risk, to those at lower risk.

More precise pricing of risk is impacting on affordability

269. A better understanding of the idiosyncratic risks faced by particular areas and particular properties has resulted in a widespread risk re-rating of properties for natural disasters, not just flood risk but also bushfire, cyclone and storm risk.

Chart 5: Insurance prices and the consumer price index

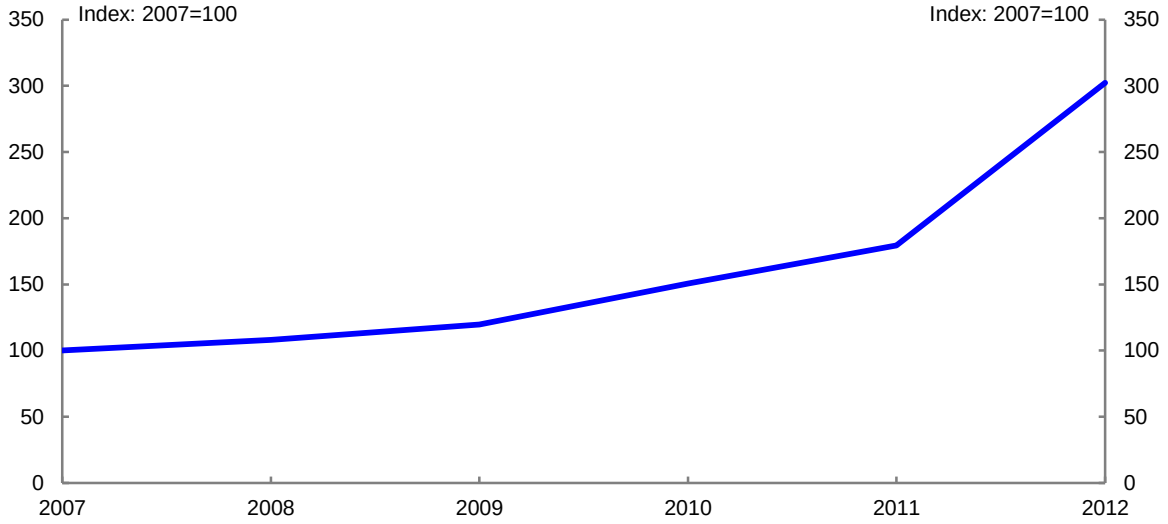


Source: Insurance Council of Australia and Treasury.

270. Premiums have been increased, in large part reflecting this new understanding of idiosyncratic risk. Insurance premium growth in two of the largest classes of general insurance, home buildings and home contents insurance, has outstripped the growth in broader consumer prices (CPI) by a factor of 2 and 1.2 respectively over the ten years to June 2013 (see Chart 5).

271. In some particular geographical regions, such as North Queensland, the increases have been sharp. The Australian Government Actuary, in an October 2012 study[74], set out data showing an average increase in North Queensland strata title property insurance prices of 200 per cent over the period 2007 – 2012 (Chart 6).

Chart 6: North Queensland gross strata title premium rates



Source: Australian Government Actuary.

272. Other factors have also contributed to the growth in insurance prices, including:

- the inclusion of flood cover to home and contents insurance policies; and
- rising levels of sums insured.

273. The policy question raised by these developments is whether the cost of better understanding risk should be borne directly by individual property owners, or whether there is a case for government intervention to share the burden. Views on this issue have been mixed.

274. The Natural Disaster Insurance Review for example, recommended the establishment of a government-backed (Commonwealth, with possible contribution from States)

[74] Australian Government Actuary, 2012

reinsurance scheme that would effectively subsidise lower insurance premiums for owners of high risk properties.[75]

275. On the other hand, the Productivity Commission's *Barriers to Effective Climate Change Adaptation* Report recommended that insurance premiums should not be subsidised directly or indirectly, as that would reduce adaptation behaviour of individuals and governments.[76]

276. Subsidising insurance premiums would likely reduce the incentive for individuals and governments to directly mitigate risks within their control, potentially raising the overall cost of such risks. For example, in March 2014 Suncorp announced premium reductions of 15 per cent in St George in Queensland following construction of a flood levee. Similar reductions were experienced in Charleville following flood mitigation work there and Suncorp expects reductions of 30 per cent following construction of a new levee in Roma.[77] There would be less incentive for governments to undertake such work if insurance premiums were to be subsidised.

277. A large part of the idiosyncratic risk problem is due to inadequate attention to mitigation. For example, buildings are not being optimised to minimise damage from storms and local government land use decisions may not sufficiently account for flood risk or build in mitigation strategies.

278. The Productivity Commission is examining the full scope of national expenditure on disasters, including the effectiveness of current mitigation support arrangements.[78] The Australian Government Actuary will also scrutinise insurance pricing in various Australian markets, with a focus on North Queensland.

279. Subsidised pooling solutions may be the only reliable way to address critical affordability issues in certain high-risk markets, but would come at the risk of inefficient allocation of resources.

[75] Natural Disaster Insurance Review, 2011
[76] Productivity Commission, 2012
[77] Suncorp Group, 2014
[78] Keenan and Hockey, 2013

The regulatory architecture for the insurance sector is broadly appropriate, though options for greater competition should be explored

280. A challenge for policy makers and regulators is to strike the right balance between promoting efficiency and competition in the insurance sector, whilst protecting the interests of policyholders, including ensuring access to affordable insurance.

281. The collapse of HIH in 2001 highlighted that robust prudential regulation and active supervision in the insurance sector is needed to ensure that poor risk and business management practices are identified and remedied at an early stage, and to ensure that consumers are protected. These lessons were reinforced by the build-up of financial risks in other nations, and the subsequent fallout from the global financial crisis.

282. A series of prudential enhancements has been implemented in Australia during the late 2000s, both by legislators and regulators—APRA in particular. APRA has now completed its Life and General Insurance Capital (LAGIC) review and the resulting changes to risk management and capital regime were put in place from 1 January 2013. It is too early to form a detailed assessment of the changes in behavioural and broad implications of the reforms. However, the Financial System Inquiry could assess if there are any areas that would merit earlier review.

283. The crisis in liability insurance of the early 2000s led to a major national tort law reform, which has improved access to affordable liability insurance. More recent reforms, such as the requirement for a standard definition of flood, have improved consumer knowledge about the terms and conditions of insurance policies.

284. Competition and contestability in the life insurance sector appears robust. As noted above, in some business lines such as group life, total and permanent disability and income protection cover, competitive pressures have driven insurers toward pricing and risk provisioning practices that were potentially not sustainable.

285. Nevertheless, in the interest of maintaining a competitive environment, it would be appropriate for the Inquiry to explore any regulatory factors that may affect the level of competition.

Life insurance

286. One potential factor for the Inquiry to explore is the current restrictions on entry to Australia's life insurance market. Requirements for foreign life insurers establishing a branch in Australia are more restrictive than for general insurance. Foreign life insurers are required to establish a local subsidiary which is subject to APRA

authorisation. The Life Insurance Act allows for exceptions to this rule for insurers from certain countries, who can apply to APRA to operate a branch. Currently, only life insurers from the United States and New Zealand can apply to APRA to establish local branches, although no foreign life insurers have yet done so.

General insurance

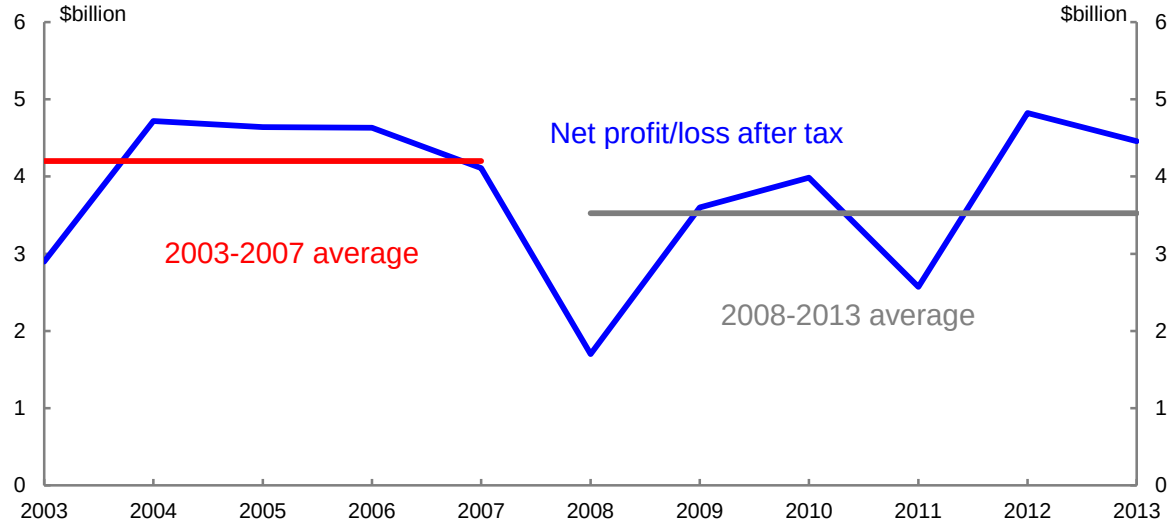
287. Australian general insurance markets are largely open to the entry of new insurers, including foreign insurers. Foreign general insurers are able to establish local branches in Australia, subject to APRA being satisfied that they meet certain prudential requirements (including that their assets held in Australia exceed their liabilities held in Australia). These requirements ensure that domestic policy holders of foreign insurers are adequately protected. The requirements also ensure foreign participants are not advantaged over their domestic competitors, by facing the same capital and prudential requirements.

288. Indicators suggest there has been an intensification of competition and contestability broadly across the general insurance sector in recent years.

- There have been new entrants offering a range of general and life insurance products and capturing market share by advertising aggressively and offering cheaper premiums and/or enhanced product features.
- There has been an emergence of 'aggregator' websites (which enable the comparison of product features and prices). These sites can reduce search and transaction costs for consumers, enabling them to compare insurance prices more easily. However, such sites can reduce consumer attention to price alone rather than a joint assessment of the price and the features of a policy.
- A number of new entrants are offering online services only, which is a far cheaper and easier way to enter the market. Incumbents are responding by establishing low-cost competitors such as Bingle (a subsidiary of Suncorp) which only operate online.

289. The contestability in the general insurance market is reflected in trends in profitability, notwithstanding a popular perception that a lack of competition is driving rising premiums. Despite strong rises in home building and home contents insurance prices since 2008, industry-wide profitability since 2008 has, on average, been lower than for the five years preceding 2008 (Chart 7), when price rises for home building and home contents insurance more closely tracked consumer inflation.

Chart 7: Industry wide net profit/loss after tax[79]



Source: APRA and Treasury.

290. While there are signs that competition is broadly robust, some insurance classes, such as for motor vehicles, house and contents and lenders mortgage insurance, continue to be characterised by high levels of market concentration. In each of these classes, a few providers account for the majority share in premiums generated across Australia, despite there being dozens of other providers.

291. The level of concentration does not in itself indicate that competition in these sub-markets is uncontested. On the contrary, reports suggest that insurers in these markets are competing vigorously for business, evidenced by the plethora of advertisements by insurance providers during prime time media slots.

292. However, not all insurance markets across Australia exhibit the same level of competition or contestability. For example, areas such as North Queensland have comparatively few insurers prepared to do business in property insurance, due to concerns over storm and cyclone risk. This is especially so in the strata title insurance market in which two insurers (Suncorp (Longitude/Vero) and IAG (CGU/SUU)) write most of the business.

293. The Financial System Inquiry should explore the scope to enhance efficiency and competition within the general insurance sector with a focus on segments of the market with fewer participants.

[79] The chart represents net profit/loss performance for direct insurers only; it does not include data for reinsurers.

Financial Claims Scheme

294. The Financial Claims Scheme (FCS) is now an established feature the financial system and can be triggered when an insurer has failed and is about to be placed into liquidation. The FCS has been triggered for a small insurance company, Australian Family Assurance Limited (AustFam) in 2009. It supports financial stability by ensuring confidence and reducing the impact of failures through quick access to funds. It could, however, distort the flow of funds in the system by diverting funds away from non-protected products.

295. At present, the FCS is funded after the scheme has been triggered and as such, those who benefit from the FCS do not pay for the benefit they derive. As with the FCS for bank deposits the introduction of a price on the insurance FCS would remedy this problem. However, in forming a view on this issue the Financial System Inquiry will need to take address the complexities in formulating an appropriate levy for the insurance sector and take account of the relatively high level of taxation on insurance products.

Capital markets

Key Points

296. The regulation of capital markets was extensively reformed following the Wallis Inquiry. This has facilitated the subsequent evolution of the markets and contributed to the strong performance of these markets through the financial crisis.

    - Australia's capital markets have evolved significantly since the Wallis Inquiry. Domestic exchanges and clearing facilities consolidated in the Australian Securities Exchange in 2006, but since then competition has emerged in the trading of securities and the clearing of derivatives and through market innovations, such as the growth of dark pools.
    - The capital markets played a key role through the financial crisis by facilitating the recapitalisation of companies through the issuance of equity at a time when the global credit markets were severely dislocated.

297. The drivers of change in capital markets — particularly technology and globalisation — can be expected to continue into the future. This underscores the need for the regulation of the markets to be sufficiently flexible to adapt to further change. Largely this is the case, though the legislative regime for licensing market operators is a key exception. In considering this issue, the Financial System Inquiry should take account of Treasury's current review of the regime.

298. Recent developments — the rejection of the ASX-SGX merger, the issue of competition in the clearing of cash equities and the entry of foreign clearing facilities — have also highlighted the tensions between stability and efficiency in the regulation of clearing facilities.

299. Clearing facilities are systemically important given their role in managing counterparty risk and are subject to regulation that promotes their stability including through the imposition of safeguards to ensure the regulators have sufficient regulatory influence over cross border clearing facilities.

300. The cost of such requirements, though, may deter market entry. In forming a view on this issue, the Financial System Inquiry should take account of the work of the Council of Financial Regulators.

Australian capital markets have evolved since Wallis

301. Australia's capital markets have undergone significant structural change over the last decade. Exchange and clearing facilities were consolidated with the merger of the Australian Stock Exchange and the Sydney Futures Exchange in 2006 into a vertically integrated operation that offers listing, trading, clearing and settlement services across a diverse range of securities.

302. However since then competition has emerged through domestic and foreign market entrants. Competition was introduced into domestic securities trading in 2011 with the entry of Chi-X Australia, and in the clearing of OTC derivatives in 2013 with the entry of UK-based clearing provider LCH Clearnet. Market innovation through the expansion of dark pools is also providing competition in securities trading.

303. Australia's capital markets are characterised by deep and liquid OTC markets that enable parties to bilaterally transact in products including foreign exchange, debt securities and derivatives. OTC turnover accounted for approximately 62 per cent of all Australian financial market turnover in 2012-13.[80] The OTC markets are highly dynamic and play a core role in the Australian financial system by providing greater scope for market participants to negotiate tailored exposures to meet specific business needs.

304. Conversely, the relatively small size of Australia's corporate bond market is an issue to be considered by the Financial System Inquiry. Australian non-financial corporations issued around $10 billion into the Australian market in 2013, compared to around $20 billion into offshore markets in the same year.[81]

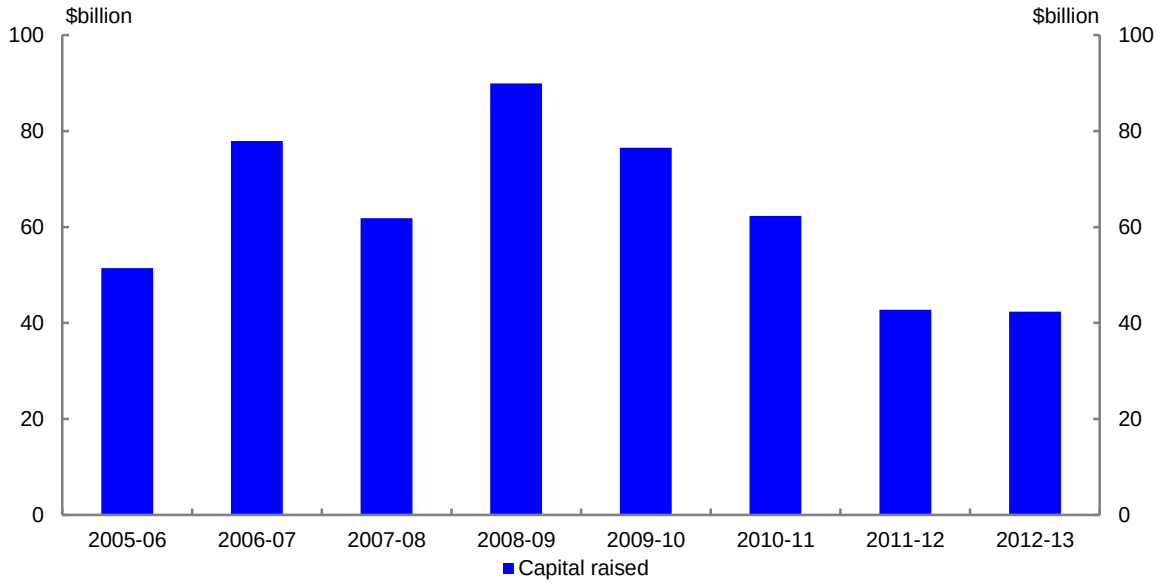
305. Recent policy changes have been designed to improve the attractiveness of Australia's corporate bond market to retail investors, including the listing of Commonwealth Government Securities on the ASX. Reforms currently being progressed will reduce the disclosure burden on bond issuers and liability risk on company directors when issuing simple corporate bonds. These reforms appropriately target regulatory impediments to the development of the market.

306. However, the small size of the corporate bond market does not appear to be a function of market or regulatory failure, but instead appears to be a market outcome that reflects the higher liquidity and lower cost of issuance in offshore markets.[82] In the absence of evidence of some form of market or regulatory failure, there is no role for government intervention to promote a larger corporate bond market.

[80] AFMA, 2013
[81] Thomson Reuters 2014
[82] Davis and Ralston, 2013, 42

307. The effectiveness of the capital markets — particularly the large and liquid equity markets — was illustrated through the financial crisis, at a time when global credit markets were severely dislocated. At that time, Australia's capital markets provided support for, and an alternative to, intermediated markets, enabling Australian corporations to recapitalise through equity issuance. The liquidity of capital markets at this time was, in part, due to an increase in equity market share by foreign investors[83] and, in part, due to the development of new tools such as accelerated rights issues (see Chart 8).[84]

Chart 8: ASX Equity Capital Raisings



Source: ASX.

Regulation of capital markets has been flexible in responding to market evolution

308. The strong performance of the equity markets through the crisis was, in part, the function of a regulatory regime designed to facilitate the evolution of the markets to meet the needs of users.

309. The regulation of capital markets was extensively modernised through the Corporate Law Economic Reform Program. In particular the *Financial Services Reform Act 2001* and subsequent amendments to the *Corporations Act 2001* introduced a regulatory

[83] Black and Kirkwood, 2010, 25

[84] Accelerated rights issues include an initial offering to institutional investors over a short period of time, followed by a second offering to retail investors along a more traditional 23 day timetable.

regime based on functions, rather than products, with the intensity of the regulation scaled to match the varying intensity of possible market failures.

310. Relatively lighter-touch regulation exists for market participants, such as through disclosure requirements and market conduct rules in order to address agency costs. More intensive regulation applies to market operators and, most of all, to clearing and settlement facilities, reflecting the greater systemic impact should failure of one of these facilities occur.

311. However, continued innovation in the operation of capital markets is likely to require an increasingly flexible regulatory framework — particularly in the area of market licensing.

312. The current legislative framework is producing a piecemeal approach to regulation as new market forms have arisen, and is too inflexible to appropriately regulate all financial markets. For instance, professional markets are regulated through licence exemptions with conditions, while dark pools are regulated primarily through market integrity rules. The Inquiry should take into account the current review into the Australian market licencing regime when considering the capacity of the current regime to adapt to ongoing market evolution.[85]

Cross border provision of clearing services highlights the tension between stability and efficiency

313. Clearing facilities are systemically important given their role in managing counterparty risk. Reflecting that importance, clearing facilities are subject to intensive regulation administered by the Reserve Bank and ASIC to promote the stability of the financial system.

314. Clearing providers rely on economies of scale and network effects in their operations as they achieve efficiencies by netting the margin obligations of their participants. The high fixed costs and economies of scale required to provide these services means that competition to the ASX is only likely to arise where foreign clearing facilities participate in the Australian market.

315. However the ability of the regulators to pursue their statutory objective of stability will involve the imposition of safeguards to ensure ASIC and the Reserve Bank have sufficient regulatory influence over cross border clearing facilities. In some cases — where a facility is systemically important and has a strong connection to the domestic market — this will involve the clearing facility incorporating domestically, holding a

[85] Treasury, 2012a

domestic licence and maintaining core operational capacity in Australia. The cost of such requirements, though, may deter market entry.

316. Recent developments have highlighted the tensions in the regulation of clearing facilities between the objectives of stability and efficiency:

- the previous government rejected in 2011 the proposed merger between the ASX and SGX in part because of the regulators' concerns about their ability to achieve their statutory objective of stability where the clearing facility was operated from offshore (the Council of Financial Regulators subsequently advised the previous government on measures to address these risks, but any possible legislative reforms to give effect to this advice are now on hold pending the outcome of the Financial System Inquiry);
- the previous government deferred the consideration of the introduction of competition in the clearing of cash equities until the start of 2015 on the advice of the Council of Financial Regulators, though this partly reflected concerns on the part of market participants (particularly brokers) about their capacity to absorb the cost of further system changes following the recent significant reforms associated with the introduction of competition in trading of cash equities and the transfer of market supervision to ASIC;
- the G20 responded to the financial crisis by requiring that over-the-counter (OTC) derivatives be centrally cleared to reduce the counterparty risk in that market, a major factor in the collapse of large financial institutions at the onset of the crisis. The market has responded to this regulatory change with two competing services receiving regulatory approval last year to clear OTC derivatives in the Australian market: the ASX and the London Clearing House Clearnet Group which was licensed as a foreign clearing facility.

317. The Council of Financial Regulators has sought to balance these objectives[86] and to provide clarity to market participants by publishing guidance on the circumstances in which regulators would recommend the imposition of requirements.[87] These requirements are a well-articulated policy framework: in forming a view on this issue the Inquiry should take account of this work.

[86] CFR, 2012
[87] CFR, 2014

Over the counter derivatives reforms

318. As noted above, the financial crisis illuminated structural deficiencies in the global OTC derivatives markets and the systemic risks those deficiencies pose for the wider financial markets and the real economy. Recent reforms by the G20 in respect of trade reporting, central clearing and platform trading of OTC derivatives have sought to improve transparency and stability in OTC derivative markets.

319. Australia established a legislative framework in 2012 to implement the G20 reforms. Australia is now engaged in developing this framework for central clearing of OTC traded interest rate swaps in a way that is tailored to the specific conditions and requirements prevailing in Australian markets.

320. International requirements for the central clearing of OTC derivatives will further increase the systemic importance of clearing infrastructure. Australia must respond to international developments by working with international regulatory bodies and bilaterally with key jurisdictions to ensure that cost-effective access to foreign markets is maintained and ensure that international regulation does not result in duplicate or conflicting regulation.

Appendix: Australia's saving and investment balance

Key points

321. Australia's open capital account has enabled the Australian economy to access global capital markets, facilitating investment that has played a crucial role in developing Australia's capital stock and boosting productivity. Accessing global capital markets also allows the Australian economy to finance its investment at the lowest cost.

322. Although there are risks associated with having a current account deficit there are a number of factors mitigating these risks for Australia. In particular, Australia's current account deficit is a reflection of the high number of profitable investment opportunities that exist in Australia, rather than a low level of domestic saving.

323. The banking system plays a key role in facilitating the flow of capital both into and out of Australia. The banks have shifted from being net accumulators of foreign liabilities to net repayers following the global financial crisis.

Australia has run a current account deficit for most of our history

324. Australia's domestic investment has exceeded domestic saving for most of our history, reflecting the profitable investment opportunities that exist in Australia. Australia's openness to foreign capital has enabled this investment to take place, increasing Australia's capital stock and improving living standards by adding to national income.

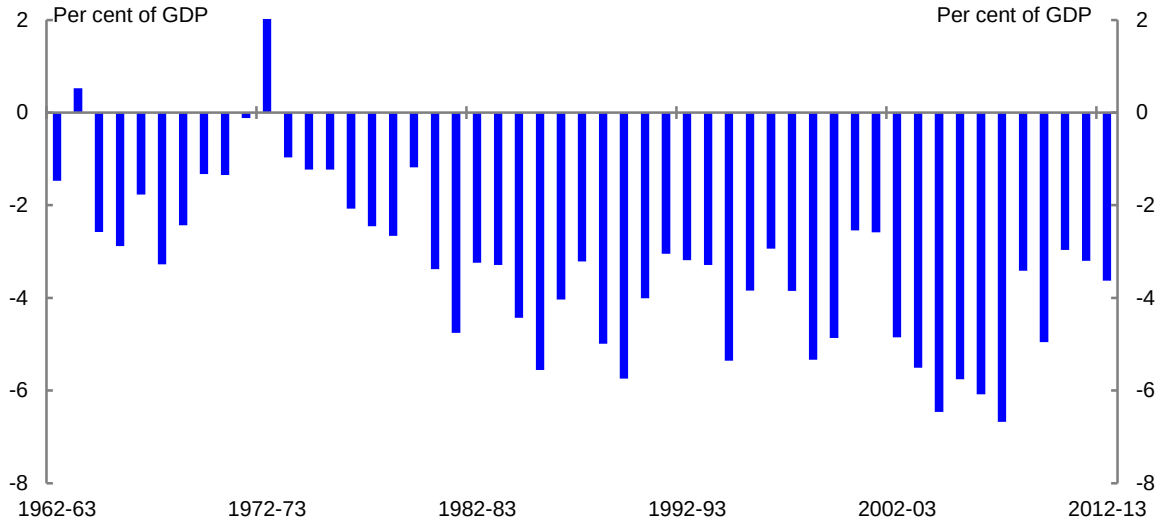
325. Accessing global capital markets also allows the Australian economy to finance investment at the lowest cost and diversifies the economy's overall funding base. Further, it allows Australian investors to pursue the highest possible risk-adjusted returns available globally.

326. The current account deficit (CAD) that has been incurred as a result of investment exceeding saving has attracted considerable debate over the past three decades (see Chart 9).[88] The rise in the CAD from the early 1980s became a central focus for

[88] Garton et al, 2010

policymakers during that decade.[89] High CADs were seen as a source of macroeconomic vulnerability and a constraint on economic growth.

Chart 9: Current account balance as a per cent of GDP



Source: ABS cat. no. 5302

327. In the early 1990s this consensus was challenged by the 'consenting adults' view, which noted that the CAD should not be seen as a problem if it is based on private saving and investment decisions that are not subject to significant policy distortions. The financial deregulation that occurred in the 1980s, along with the prudent management of fiscal policy, enabled the preconditions for this view to be met in Australia.

328. Over time this view increasingly became accepted as the CAD remained high with few adverse implications. The shift towards a more relaxed view of the CAD was assisted by improved macroeconomic policy frameworks and structural reforms that enhanced confidence that the preconditions for the 'consenting adults' view were being met.

329. The ability of Australian financial institutions to borrow offshore in Australian dollars, or hedge back into Australian dollars, further alleviated fears surrounding the CAD.

The current account deficit is the difference between investment and saving

330. Balance of payments accounting defines the current account balance as the sum of the trade and net income balances. In a direct sense, Australia's CAD reflects the fact

[89] Gruen 2005 and Belkar, Cockerell and Kent 2007 for discussions on the evolution of the debate on Australia's current account deficit

that imports and income paid to foreign residents exceed exports and income received from abroad. However, the CAD can just as validly be thought of in two other ways:

- acquisition of Australian assets by foreigners exceeds Australian acquisition of foreign assets; and
- domestic investment exceeds saving by Australian residents.

331. The saving-investment perspective is often the most useful as it recognises that the CAD reflects economy-wide factors. This helps to identify influences that can be overlooked by focussing on external transactions.

332. For instance, it may seem counter-intuitive that the rise in Australia's terms of trade during the first phase of the mining boom was associated with a widening CAD, given its direct effect is to reduce the trade deficit. However, viewed from a saving-investment perspective, high profits in the resources sector led to a surge in investment that drove a widening of the CAD.

333. A saving-investment perspective also emphasises that the current account is best viewed in inter-temporal terms. Saving and investment are means for increasing future consumption by diverting output from current consumption. Hence, CADs can be considered optimal if they are consistent with achieving an optimal consumption path over time.

334. For instance, CADs that finance higher levels of productive investment can raise the economy's future output potential, allowing higher levels of consumption in the future. Running CADs when income is unusually low or investment is unusually high also allows consumption to be smoothed over time.

335. In contrast, an increase in the CAD that is caused by a fall in national saving implies that foreign borrowing is being used to finance higher current consumption at the expense of future consumption. A fall in saving may be appropriate to smooth consumption over periods when national income is low relative to its expected future path. However, a persistent fall in the saving rate may require other adjustments in the economy to ensure the sustainability of a country's net foreign liability position.

336. As gross national saving and investment includes both public and private saving and investment, the consolidated fiscal position of all levels of government also influences the CAD. For instance, large increases in government consumption will, all else equal, lead to a widening in the CAD while higher government saving will narrow the CAD.

The current account deficit is an outcome of gross capital flows

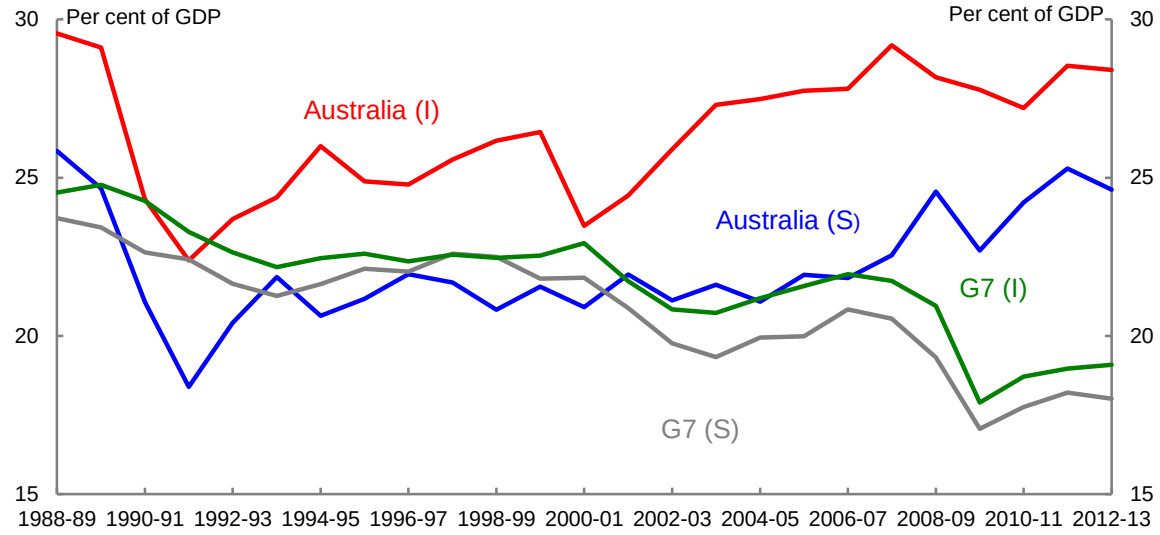
337. Although the CAD is a reflection of the net capital inflows into the Australian economy (acquisition of Australian assets by foreigners exceeds Australian acquisition of foreign assets), these net flows are an outcome of much larger gross flows. Thus when considering the extent to which domestic investment is financed onshore versus offshore, it is necessary to look at the gross flows rather than the net outcome.

338. For instance, while an increase in domestic saving results in a reduction in the CAD, it does not necessarily change the extent to which domestic investment is financed onshore. If the preferences of Australians are such that they wish to allocate a certain portion of their savings offshore to diversify their assets, an increase in saving could result in an increase in gross flows out of Australia, a fall in the CAD and no change in offshore funding of Australian investment.

Australia is a high saving country

339. Australia's CAD reflects the large number of investment opportunities in Australia, rather than a lack of domestic savings (see Chart 10). Indeed, compared with major advanced economies, Australia has a very high level of national saving, which is a consequence of comparatively strong fiscal management and a maturing superannuation system.

Chart 10: Gross saving and gross investment



Source: ABS cat. no. 5206 and IMF.

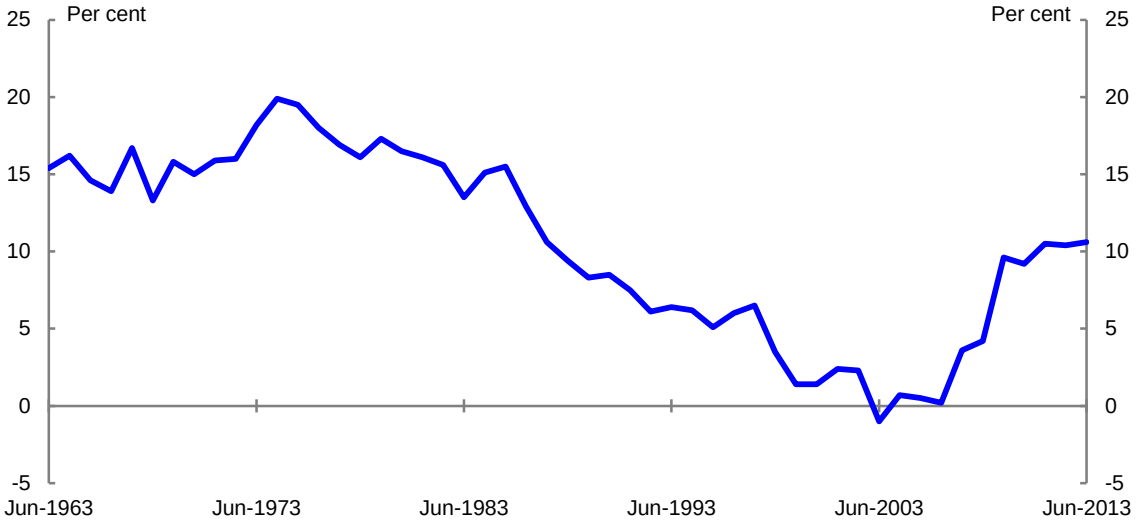
340. The major driver of national saving since the mid-2000s has been a turnaround in the household saving rate (See Chart 11). The rise in household saving may reflect

households returning to more normal patterns of behaviour.[90] The unusually low saving rates and high levels of borrowing during the 1990s and early 2000s was likely a result of households transitioning to a desired level of debt following the reforms of the 1980s and 1990s, including financial market deregulation and inflation targeting.

341. Another likely contributor to the fall in household saving was strong asset price growth, particularly housing. Capital gains reduce the need to save out of current income in order to accumulate wealth, but are not included in the conventional definition of saving.

342. The increase in household saving following the GFC is also consistent with more cautious consumer behaviour following the global financial crisis. However, while this caution has increased household saving, it has not led to widespread deleveraging, with the household debt to disposable income ratio only falling marginally since the global financial crisis — from a peak of 152 per cent to 149 per cent in December 2013.[91]

Chart 11: Household saving ratio



Source: ABS cat. no. 5206.

343. Changes in government saving have also impacted on Australia's national saving rate. In the early 2000s the government added to national saving at a time when households were detracting from national saving. In contrast, since the global financial crisis the government has detracted from net national saving. However, the rise in household saving has more than offset the decline in government saving.

[90] Freestone 2011 et al, Lowe 2012
[91] See RBA statistics B.21

Investment returns matter

344. Concerns surrounding the current deficit are generally focused on two issues:

- what will occur when the providers of foreign capital require returns from their investment; and
- the risk that there will be a sudden stop in offshore funding.

345. Foreign providers of capital expect to receive a return from their investment in Australia, either in the form of principal and interest repayments for debt financing or dividends and capital gains for equity investments.

346. For this reason, the quality of the investment funded via the CAD is important. If the CAD has been used to fund productive investment, then repaying the foreign providers of capital should not be an issue. If on the other hand, foreign financing has been used to fund unproductive investment, for instance as a result of a government distortion favouring one type of investment over another, the CAD may pose a risk to stability.

347. The 'consenting adults' view of the CAD is premised on the notion that the private sector will allocate capital to its most productive use, taking account of the risks involved. In the absence of distortions the private sector would be expected to utilise foreign funding to finance productive investment which is capable of generating the returns needed to repay investors.

Investment in Australia has increased Australia's productive capacity

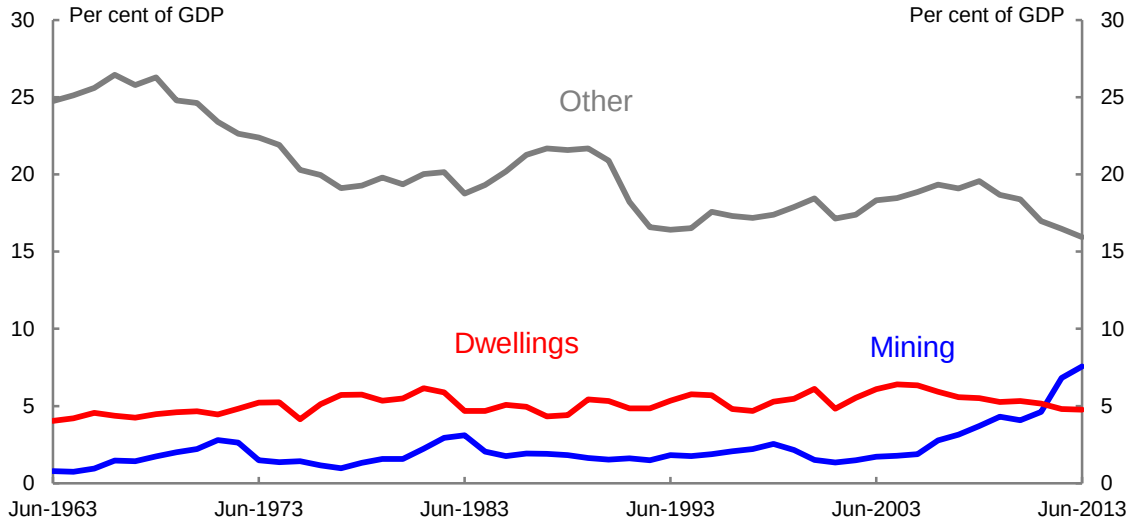
348. The main contributor to rising national investment since 2004-05 has been mining investment, which surged in response to high commodity prices arising from strong demand from China and other emerging economies (see Chart 12).

349. This investment will expand the nation's capital stock, boosting Australia's productive capacity and GDP. The large investment in mining that occurred over the 2000s is expected to result in a significant increase in exports. Thus, investment in Australia has primarily been directed towards a productive use. Provided the returns on investment exceed the cost of capital, including the cost of servicing any foreign borrowing, this investment will raise future national income.

350. Dwelling investment (which includes dwelling construction and alterations and additions) has remained relatively constant at around 5 per cent of GDP over the past

30 years. As such, changes in the CAD have generally not been driven by changes in dwelling investment.

Chart 12: Composition of gross investment



Source: ABS cat. no. 5204.

Fear of a sudden stop

351. The other common concern regarding current account deficits is the fear of adjustment should the supply of foreign capital suddenly stop. However, most of these concerns appear to be more relevant to a country operating with a fixed exchange rate rather than countries with a floating exchange rate, such as Australia.

352. From a national accounting perspective, capital inflows are equal to the current account deficit plus the accumulation of foreign reserves.[92] With a fixed exchange rate, a sudden stop or reversal of capital inflows will require either a fall in the current account deficit or a fall in foreign reserves. In the absence of a large pool of foreign reserves, the current account adjustment would be facilitated through a fall in domestic demand in order to move the trade balance to surplus, which could result in a recession.

353. However, this scenario is unlikely to unfold in a country with a floating exchange rate. Instead the main mechanism of adjustment would be a depreciation in the exchange rate, rather than a sudden change in the current account position. Although there would be a fall in real wealth and income, this would not necessarily lead to a recession.

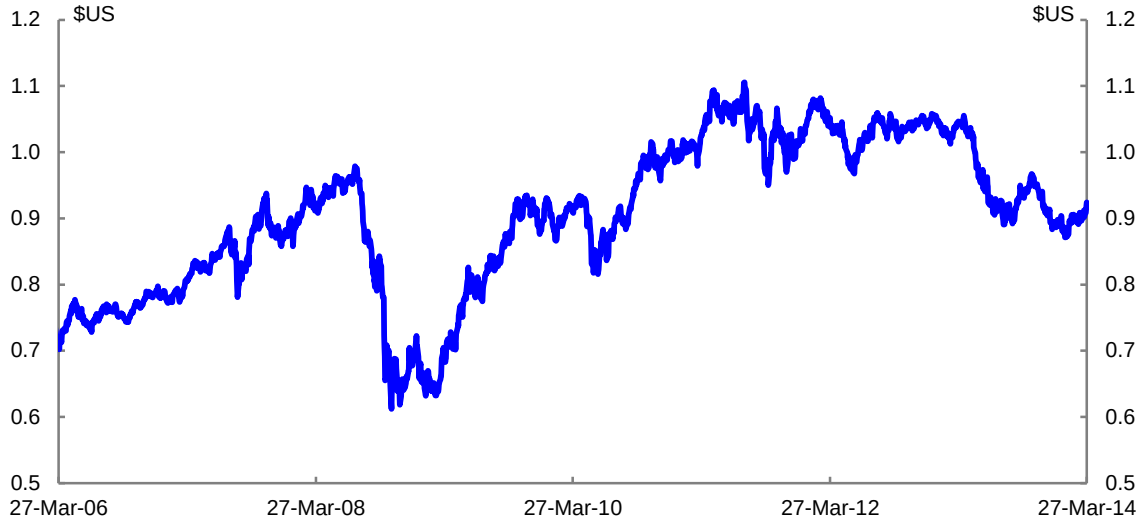
[92] Reinhart and Calvo, 2000

354. For instance, if foreign investors suddenly reduced their demand for investment in Australia, the Australian dollar would depreciate to the point where investors were once again comfortable with their Australian allocation in their overall portfolio.[93] However this assumes the foreign capital markets are continuing to function and Australian institutions are able to issue into them, an assumption that was tested through the dislocation of the global credit markets during the financial crisis.

355. Australia's strong institutions — including, the Commonwealth's strong balance sheet, the sound financial system, the floating exchange rate and a credible inflation targeting regime — have enabled the Australian economy to weather quite substantial changes in capital flows without a financial crisis.

356. The global financial crisis provides a good example of a situation where a sharp depreciation in the Australian dollar shielded the domestic economy from an external shock (Chart 13). Rather than being seen as a sign of distress, the fall in the Australian dollar assisted the economy during this turbulent period.

Chart 13: Australian dollar



Source: RBA Statistics F.11.

Offshore funding

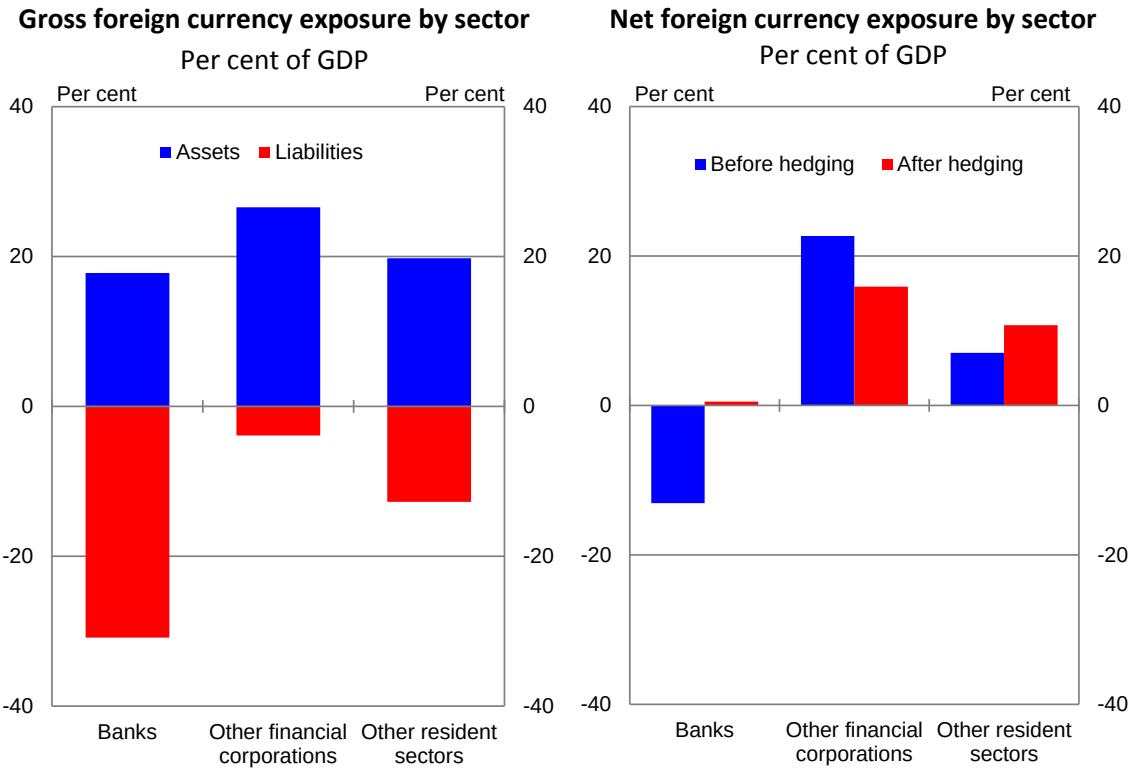
357. The extent to which the banking sector utilises offshore funding is often cited as a risk for the Australian financial system.[94] However, while there can be risks associated with accessing any source of funds, there are a number of factors that mitigate the risks of offshore foreign currency funding.

[93] Debelle, 2011
[94] IMF, 2014

358. Although offshore funding typically involves taking on a foreign currency denominated liability to fund Australian dollar lending, this risk is largely mitigated by hedging. Indeed, even though the Australian banking system had a net foreign currency liability position equivalent to 7 per cent of their total assets before hedging in 2013, after hedging banks actually had a small net foreign currency asset position (see Chart 14).[95]

359. The fact that Australia's foreign currency assets exceed the value of its foreign currency liabilities means that a fall in the exchange rate actually improves the overall net asset position.

Chart 14: Foreign currency exposure



Source: ABS cat. no. 5302.

360. Despite borrowing in foreign currency, as a result of this hedging Australian banks effectively borrow in Australian dollars, meaning there is no currency mismatch between their assets and liabilities.

361. As such, in the event of a liquidity crisis, Australian banks would not be in a position where they have to roll over a funding position in which they cannot access central bank liquidity, as the Reserve Bank can provide Australian dollar liquidity. This is in

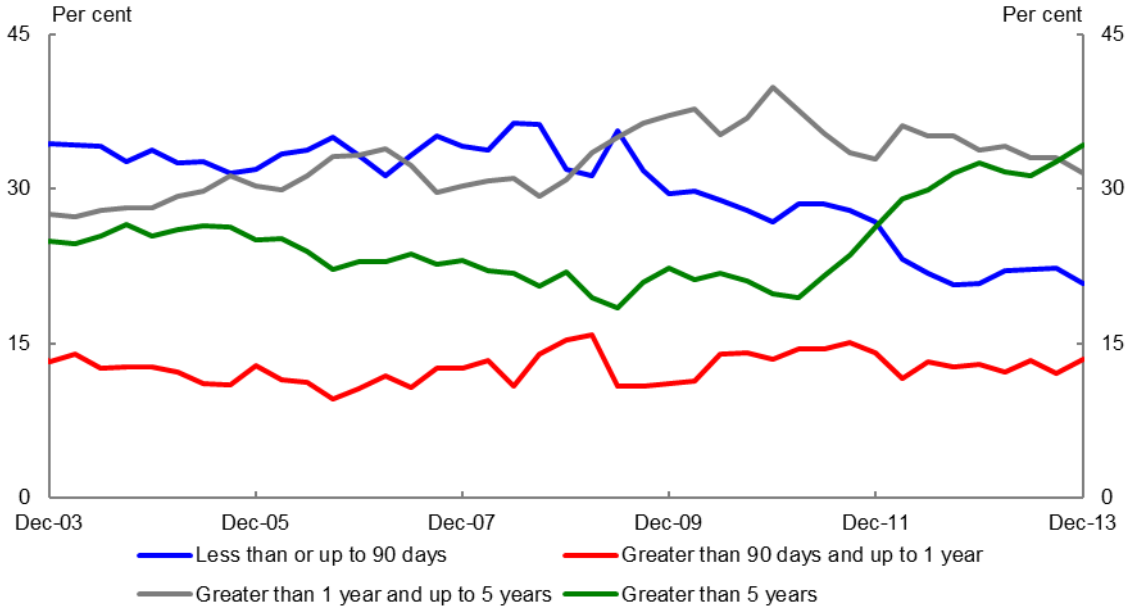
[95] RBA, 2013

contrast to many banks in the euro area during the global financial crisis, which had to meet US dollar liabilities with support from the European Central Bank.[96]

362. Further, when considering the risks associated with offshore funding it is important to consider the composition and tenor of the funding. For instance, a 5-year medium term note placed offshore has less rollover risk than a domestic 90-day bank bill.

363. Following the global financial crisis, Australia's use of long-term debt with a maturity greater than 5 years rose, primarily at the expense of short term wholesale funding (see Chart 15). This has occurred in response to pressure from regulators and markets as disruptions to global financial markets made rolling over short term foreign debt difficult during the global financial crisis.

Chart 15: Maturity of Australia's foreign debt



Source: ABS cat. no. 5302.

364. Offshore funding can also reduce overall bank funding costs. Australia's robust prudential regulatory framework plays an important role in lowering the cost at which Australian banks can borrow offshore by lowering the risk premium that foreign investors attach to Australia. This makes offshore funding cost-effective.

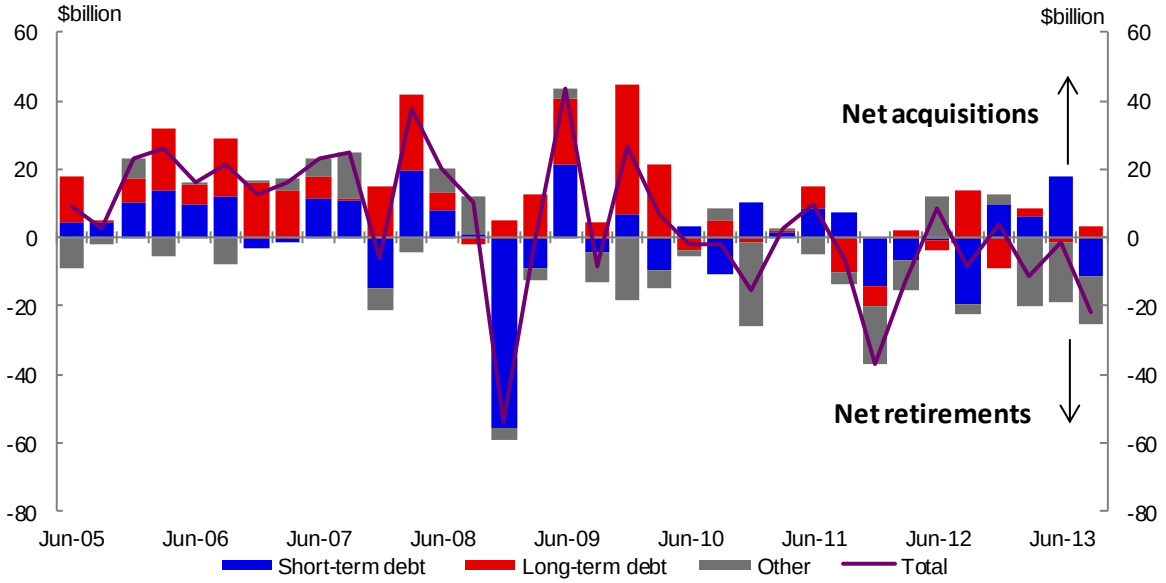
365. Obtaining offshore funding diversifies Australian bank's funding base by increasing their exposures over a greater number of investors, markets, products, and currencies. This helps guard against liquidity stress and significant funding cost increases.

[96] Bailey et al, 2012

366. In addition, since around 2010 the Australian banking system has been a net repayer of its offshore liabilities (see Chart 16). This is mainly a result of a push by regulators and rating agencies for banks to increase their use of deposit funding at the expense of wholesale funding, rather than a fall in demand for Australian bank debt.

367. Since around 2010 the key driver of the CAD has been resources investment, which has primarily been financed through internal resources such as retained earnings.[97] Thus, equity flows to the mining sector have effectively 'funded the CAD', rather than the banking sector.

Chart 16: Banks offshore liabilities



Source: ABS cat. no. 5232.

[97] Debelle, 2013

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