AFMA

AUSTRALIAN FINANCIAL MARKETS ASSOCIATION

Submission to the Consultation on Financial System Inquiry Final Report

31 March 2015

About AFMA

AFMA is the industry association for participants in Australia's securities and OTC financial markets. The Association's Objectives cover policy advocacy, promoting the development of efficient and competitive financial markets, industry self-regulation in addition to promoting high professional standards education and data services.

AFMA has over 130 members, including Australian and international banks, all of the leading stockbrokers, securities companies, state government treasury corporations, fund managers, traders in electricity and other specialised markets and industry service providers.

AFMA represents Members' interests in dealings with governments and regulatory authorities on issues that affect the business of members and the capital markets generally.

Promoting Market Efficiency

Market Governance

AFMA's key mandate is to promote best practice in financial markets so they can continue to maximise their contribution to the economic health of Australia. We achieve this by promoting effective self-regulation of the OTC markets through efficient and ethical market practices, conventions and standard documentation.

Financial Operations

AFMA's market governance role is complemented by the development of widely-accepted industry standards for transactional processing. This ensures that operational aspects of financial transactions, in particular confirmation, settlement, reconciliation and risk management processes are globally-recognised best practice.

Promoting Market Integrity

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

Promoting Market Professionalism

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

Market Data and Documentation

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

CONTENTS

1. EXECUTIVE SUMMARY AND AFMA RECOMMENDATIONS TO GOVERNMENT

AFMA welcomes the Final Report of the Financial System Inquiry as a valuable contribution to thinking about the future development of the Australian financial system. Many of the Final Report's recommendations are consistent with AFMA's objectives in promoting an efficient and competitive financial system and fair and effective financial markets.

At the same time, AFMA note that the Final Report falls short of providing a comprehensive strategy for guiding the future development of the financial system, its role in the Australian economy and its integration with the rest of the world, particularly the rapidly growing trade in financial services in the Asia region.

It remains incumbent on Government to formulate and then champion at the political level a strategy that will integrate the Final Report's recommendations with the Government's policy agenda in related areas such as tax, international trade and business investment. This may require a commitment of additional policy resources and political attention, particularly on the part of Treasury and the Treasurer. Many of the Final Report's recommendations raise important issues in relation to implementation and their relationship with developments internationally. AFMA also emphasise the need for close consultation with industry on the Report's recommendations and industry's willingness to engage with Government on questions of implementation. AFMA welcomes the Government's willingness to consult on the Final Report.

This submission addresses the Inquiry's recommendations and follows the same structure of the Final Report. AFMA's main recommendations to Government are as follows:

- AFMA submits that the Australian Government needs to formulate and embrace a coherent strategy for the future development of the Australian financial services industry and its integration with Asia and the world economy. The strategy can then be used to benchmark Government policy initiatives, including implementation of the FSI Final Report's recommendations.

- AFMA support the Final Report's call for the development of harmonised international reporting standards for capital adequacy.

- Australian policymakers and regulators should continue to adopt a cautious stance towards greater use of bail-in securities to increase loss absorbing and recapitalisation capacity and should monitor international experience with these instruments.

- The Government should retain Section 67A of the *Superannuation Industry Supervision Act*, in respect of limited recourse borrowings to acquire listed and widely held assets or units, as defined in the taxation legislation. Such an amendment would reinstate the initial policy intention of allowing superannuation entities to borrow on a limited recourse basis to invest in instalment warrants. The amendment may be easily done through an amendment to the definition of "acquirable asset" in Section 67A(2) to include a listed or widely held share or unit, applying the same legislative construction as used in the taxation legislation.

- AFMA remains of the view that establishment of an Inspector-General of Regulation is a better approach than the proposed Financial Regulator Assessment Board. The establishment of either an IGOR (or FRAB) will necessitate giving appropriate powers to either body along with resourcing and other administrative arrangements. Any perceived "red tape" or bureaucracy issues are outweighed, in AFMA's view by the benefits that a robust oversight process could produce for the financial sector.

- If the Government decides that an IGOR is not appropriate, AFMA supports the introduction of a Financial Regulator Assessment Board as a starting point for an improved system of regulator accountability and oversight. AFMA also supports the inclusion of AUSTRAC within the scope of the Board's responsibilities. However, careful attention will need to be given to the Board's independence from Government, the flexibility of its work program, its powers to compel documents and evidence and the creation of mechanisms that would allow the regulated community to raise issues with the Board without prejudice. Consideration will also need to be given to how the Board's oversight will complement and work with existing accountability mechanisms, such as the parliamentary committee system.

- AFMA supports the Government entering into long-term funding agreements with ASIC and other regulators to provide more predictability and certainty in Government funding. However, AFMA believes that this can be achieved without a change to an industry funding model.

- If an industry funding model is to be adopted, careful attention will need to be given to the mapping of ASIC's regulatory costs on to regulated entities and activities to ensure an equitable and proportionate burden on industry. The burden of cost recovery should fall on fee for service arrangements rather than on regulatory activities that have the characteristics of a public good. Cost recovery arrangements need to take account of the full range of costs and public and private benefits arising from the regulated activity and the overall burden being imposed on industry through other cost recovery arrangements, be they existing or proposed. AFMA is disappointed about the lack of regard for, or even awareness of, the quantum effects of cost recovery arrangements on industry where participants are paying multiple levies in relation to different regulators.

- Any legislative obligation in relation to product design and distribution will need to recognise the existing statutory roles and responsibilities of product issuers compared to licensees who provide financial advice to retail consumers.

- AFMA has no objection to enhancement of ASIC's powers to include banning individuals from managing a financial services business, subject to the normal procedural fairness issues and natural justice.

- To mitigate the risk that ASIC will seek to invoke the product intervention power post-issue of a product, it may be preferable to formalise the pre-issue process, akin to the prospectus registration process that existed in the Corporations Act prior to the CLERP 6 reforms in the late

1990s. For example, a requirement could be introduced that new products (ie. products of a type that are not currently available to retail investors), or products with particular characteristics that make them more complex than other products, cannot be issued until they have been subject to a review process by ASIC.

- Should the Government be minded to adopt the Inquiry's recommendation in relation to corporate bonds, AFMA and its members will take a leadership role in the development of standard terms and conditions, and appropriate disclosure. It has been noted that there may be resistance to this proposal due to concerns about the quality of disclosure, and the level consumer understanding about investing in bonds. However, there is an opportunity to develop innovative documentation and new forms of disclosure that are not subject to the constraints of the current disclosure regime in the Corporations Act.

- AFMA supports the proposal at Recommendation 44 of the Final Report that market ownership restrictions should be removed from the Corporations Act 2001 once the current reforms to cross-border regulation of financial market infrastructure are complete.

- A number of the taxation observations noted in Appendix 2 of the Final Report have not been reflected in the Tax Discussion Paper released on 30 March 2015. Others have been raised in only a cursory manner. We request the Government provide clarity to stakeholders about the appropriate forum to ensure that all observations in Appendix 2 of the Final Report in relation to tax are appropriately consulted upon.

2. INTRODUCTION

This submission reviews the background and context to the Final Report and makes some observations about its relationship with its predecessors, the Campbell (1979) and Wallis (1997) reports. It summarises the submissions made to the inquiry by the Australian Financial Markets Association (AFMA) in its role as the representative body for Australian financial institutions and wholesale financial markets. It reviews the Final Report's recommendations from an AFMA perspective and makes recommendations to Government in response.

The submission follows the structure of the Final Report in considering the key recommendations that are of particular interest and concern to AFMA and its membership. The submission addresses the main recommendations in relation to financial system resilience, superannuation and retirement incomes policy, the regulatory architecture of the financial system, outcomes for consumers and the corporate bond market. We discuss some of the issues raised by these recommendations, and highlight potential problems that will need to be addressed by policymakers and regulators in formulating their response to the report.

AFMA's submission also deals with matters important to Australia's financial markets that are not covered in the FSI Final Report. For the purposes of this consultation, AFMA have not focussed on the taxation observations included in the body and appendix two of the Final Report. These issues will be addressed as part of the formal Tax White Paper process. However, AFMA make some limited observations in this submission on the manner in which the Inquiry addressed taxation issues and the relationship between the Inquiry and the Tax White Paper process.

3. BACKGROUND AND CONTEXT

There were two motivations behind the Murray inquiry. The first motivation goes back to the 1997 Wallis inquiry into the financial system, which envisaged a 10-year timeframe before another review of the financial system would be undertaken. The overview chapter of the Wallis report was headed 'The Financial System: Towards 2010,' giving an indication of the timeframe the report had in mind for its recommendations. The Final Report has appeared closer to two decades after Wallis, so there was a sense that another review of the financial system was overdue. Like Wallis, the Murray review is billed as a blueprint for the next decade.

The second motivation was the financial crisis of 2008-09. The crisis is often characterised as global in scope, but while it had global implications, its epicentre was the US housing market and the US, UK and European banking systems. From Australia's perspective, the crisis was an external shock, one which we weathered very well. Much the credit for this outcome goes to the flexibility and resilience that was built into the Australian economy through the macroeconomic policy and regulatory frameworks adopted from the early 1980s. The floating of the Australian dollar in 1983, the shift to an independent, inflation targeting central bank from 1996 and the regulatory framework for the financial system put in place by the 1997 Wallis inquiry all played at least some role in insulating Australia from the shock to the global financial system and economy. When the crisis hit, Australian financial institutions had very little direct exposure to losses on mortgage-backed securities and related products.

The Murray inquiry has taken the recent financial crisis as a template for the negative shocks the Australian financial system should be designed to withstand. In particular, Murray has highlighted Australia's dependence on foreign capital inflows to fund its investment and economic growth as a key potential vulnerability. This is not a new concern. Australia's reliance on foreign capital has long been a preoccupation of policymakers. The financial crisis of 2008-09 is exactly the sort of dislocation in global credit markets to which Australia has long been thought vulnerable. Yet the demonstrable resilience of the Australian financial system and economy to a major international credit market shock calls into question some of the conditioning assumptions for the Final Report's recommendations.

This context helps explain the widely held sense that the Final Report lacks an overarching philosophy or strategic framework of the type that informed its predecessors, the Campbell and Wallis reports.[1] The 1979 Campbell inquiry was given terms of reference that noted 'the importance of the efficiency of the financial system for the Government's free enterprise objectives and broad goals for national economic prosperity.'[2] The inquiry was effectively given a deregulatory mandate in its terms of reference. The Wallis inquiry was notable for devoting a chapter of its Final Report to a 'Philosophy of Financial Regulation,' a philosophy which clearly informed its recommendations.

[1] For examples of commentary to this effect, see Jeffrey Carmichael, 'Report Tinkering Doesn't Fix Incentives Problem,' *Australian Financial Review*, December 15, 2014; Richard Holden, 'Even for David Murray, There Are Some Things Best Left Alone,' *Australian Financial Review*, December 12, 2014.

[2] *Australian Financial System. Final Report of the Committee of Inquiry* (Canberra: AGPS, 1981), xxiii.

By contrast, the Final Report was built around the 'general themes' of 'funding the Australian economy' and 'competition,' as well as some contextual discussion of population ageing, technology and the rise of Asia. Yet these trends were already well established at the time of the Wallis inquiry. This thematic approach did not lend itself to the development of a unifying analytical framework. The Final Report's final recommendations give the impression of a housekeeping exercise, geared to addressing the issues of the moment, rather than establishing a new strategic direction for the financial system.

The Final Report also appears against the backdrop of a significant overhaul of regulatory frameworks for financial markets globally in response to the financial crisis. Among the more significant changes are those being made to capital adequacy and liquidity standards as well as over-the-counter derivative markets under the auspices of the G20 and the Financial Stability Board. The Final Report benchmarks some of its key recommendations to these international developments. However, many of the reforms being introduced at a global level have yet to be bedded down, creating uncertainty as to how the Final Report's recommendations will sit in this context. There is also uncertainty arising from imperfect coordination and harmonisation of regulatory reform measures across different jurisdictions, most notably the US and EU. There is also a risk that many of these global initiatives are over-fitted to the 2008-09 financial crisis. This over-fitting to recent history risks creating new vulnerabilities.

The Final Report has been billed as the 'Son of Wallis' and 'Granddaughter of Campbell'. However, there are significant differences in the scope and depth of the Final Report's recommendations compared to its predecessors. Unlike the Campbell and Wallis reports, the Final Report will not result in major changes to the architecture of the Australian financial system. This is not necessarily unwelcome given the demonstrable resilience of the Australian financial system to recent shocks. However, there is still a need to develop a strategic framework for the future development of the Australian financial system that can be championed at a political level. The Report provides some of the elements for such a framework, but falls short of providing a new strategic direction or new institutional capacity for the implementation of its recommendations. The report's recommendations are not sufficiently geared to the tasks of enhancing Australia's economic growth and development and the need to integrate with the rapidly developing financial services trade in the Asia region.

AFMA recommendation to Government

AFMA submits that the Australian Government needs to formulate and embrace a coherent strategy for the future development of the Australian financial services industry and its integration with Asia and the world economy. The strategy can then be used to benchmark Government policy initiatives, including implementation of the FSI Final Report's recommendations.

4. AFMA SUBMISSIONS AND PERSPECTIVES

4.1 Introductory Comments

As noted above, the catalysts for the Murray Inquiry were twofold: the time that had passed since the 1997 Wallis Inquiry and the Global Financial Crisis (GFC) of 2008-09. In this light, and given the broad themes underpinning the Murray Inquiry's terms of reference of funding the Australian economy and competition, AFMA understood the possibility (and indeed the eventuality) that the recommendations of the Inquiry would not result in major changes to the architecture of the Australian financial system but rather tackle bespoke issues that had arisen or been magnified during the crisis and subsequently.

In framing both of AFMA's submissions to the Inquiry, made on 31 March 2014 and 26 August 2014, we adopted a context that 'Australia's securities and derivatives markets have performed well in serving the economy since the time of the Wallis Financial System Inquiry, including throughout the Global Financial Crisis,'[3] that is, there was not the case for wholesale structural reform of these markets. More particularly, in serving the economy, AFMA took the view the financial system had discharged its core functions of intermediating saving and investment in a way that promotes the efficient allocation of capital, liquidity and risk in the economy and that these core functions of the financial system need to remain front of mind in assessing the financial system and making recommendations.

AFMA did, however, note some market developments in the period subsequent to the GFC, including:

- The contraction of the short-term money market;
- Declining turnover, compression of commissions and new regulatory costs being imposed on equities brokers, which has led to significant pressure being exerted on that sub-set of the system;
- Increase in the share of financial system assets held by banks; and
- A reduction in the market share of foreign banks by approximately 50%.

Ultimately, our submissions were framed by the following principles:

- A strong economic performance by Australia is reliant on well-functioning wholesale banking and financial markets;
- Well-functioning wholesale banking and financial markets depend in part on good regulation, which is the outcome of a capable regulator implementing an objective and well-substantiated Government policy position; and

[3] AFMA, *Submission to the Financial System Inquiry*, 31 March 2014, 8.

- The financial system requires regulatory and tax policy settings that support its development.

In this light, AFMA urged the Inquiry to make recommendations not just in respect of how to regulate financial markets, as has been the trend both domestically and internationally in response to the GFC, but also to consider recommendations to grow the markets to ensure they continue to meet the needs of the economy. In making its recommendations, it was clear that the Inquiry would need to need to balance a number of often-competing objectives, such as innovation, competition, stability, consumer protection and contribution by the system to the Federal Budget.

We hoped the Inquiry would suggest a clear strategic direction on how the financial system ought to develop, given our view that such a strategic vision was lacking and the Inquiry was well-placed to assist the Government in the formulation of such direction.

4.2 Government Policy Settings

AFMA noted that Government policy settings will ultimately be a 'key influence on financial market development.'[4] Accordingly, AFMA advocated the following to ensure that such policy settings continue to serve the wider community:

- Maintenance of policy-making authority by Parliament and not delegation to regulatory agencies, with a need to ensure that regulator mandates were clearly defined and adhered to;
- An intellectually strong and well-resourced Department of Treasury;
- Ensuring that the administrative role of regulators remains separate and distinct from the policy making role of Government and the policy advisory role of Treasury;
- Additional industry involvement in the regulatory process, including through self-regulation where appropriate.

It is clear that, at least in respect of the first three of these principles, there remains significant progress to be made. We continue to be concerned regarding the resources within the Department of Treasury, which has seen a reduction of about one-third in its staff numbers since 2011, notwithstanding increased requirements from commitments such as Australia's presidency of the G-20. Any slack that arises from the reduction in Treasury resourcing is generally picked up by regulators, as evidenced, for example, by the ATO taking the lead on consultations on new law with respect to instalment warrants and the GST on cross-border transactions. This necessarily blurs the distinction between the role of the Government, its agencies and the regulators who should be responsible for discharging policy as opposed to making it.

With regard to self-regulation by industry stakeholders, it was noted that industry bodies bring a deep understanding of the commercial imperatives and business models of participants and ensure

[4] AFMA, *Submission to the Financial System Inquiry Interim Report*, 26 August 2014, 8.

that regulatory responses are targeted accordingly. Any self-regulatory proposals can then be endorsed by regulators, thereby giving appropriate authority. The Final Report identifies and endorses a number of instances where AFMA has developed regulatory responses in the form of conventions and principles.

4.3 Australian Financial Regulation in a Global Context

One development that AFMA specifically referenced in its submissions to the Inquiry was the increasing influence that international bodies such as the International Organisation of Securities Commissions (IOSCO) were having on the regulation of the Australian financial system. Two primary recommendations from AFMA flowed from this observation.

Firstly, as a significant stakeholder in the international processes, it is incumbent upon Australia to ensure that the arrangements for the governance of international standards setters should be guided by the same principles of transparency, predictability, participation, reasoned and timely decision making and accountability that are ideally applied in Australia. International standard setting is less amenable to the effective application of these principles given the dispersion of policy and parliamentary oversight of this activity, but these principles are important in promoting high quality global standard setting and to mitigate the likelihood of conflicts arising between the requirements imposed globally vis-a-vis those imposed domestically.

Secondly, and following on from the recommendation above, it is incumbent on Australian Governments and regulatory agencies to ensure that, to the extent possible, domestic regulatory responses mirror those imposed by international standard setting agencies. That is, the industry requires a globally consistent approach to the standards and rules.

4.4 The Inquiry's Approach to Taxation

Appropriate taxation arrangements are fundamental to the performance, efficiency and effectiveness of the financial system. Tax policy must work hand in hand with regulatory policy in promoting an effective and competitive financial system.

While the specific taxation measures observed in the Final Report are beyond the scope of this submission, AFMA is intrigued by the approach adopted by the Inquiry to taxation matters. In particular, the approach of merely making observations regarding the taxation settings that 'distort the allocation of funding and risk in the economy'[5] so as to inform the Government's proposed Tax White Paper process, as opposed to being the subject of firm recommendations, was perplexing.

The Inquiry itself acknowledges in certain areas the significant impact that taxation settings have on the efficiency of the system, either through the imposition of barriers that stymie innovation or distort decisions, or through providing concessions that are not appropriately targeted and operate

[5] Australian Government, *Financial System Inquiry Final Report*, November 2014, 277

inconsistently with the objectives they are seeking to promote.[6] These areas would be ripe for recommendations. However, the Inquiry curiously suggests that where there are relevant considerations that are beyond its scope, such as the wider tax system, it is unable to make specific recommendations.

The existence of the Tax White Paper process should not absolve the Inquiry from making recommendations on matters that it believes fundamentally affect the financial system and its future development. Indeed, given the breadth of the Terms of Reference for the Tax White Paper, it was in AFMA's view incumbent on the Inquiry to make recommendations on specific matters to ensure that the White Paper process addresses such matters in the context in which they were raised. The rationale for failing to make taxation recommendations, being the existence of broader considerations, is scarcely distinguishable with other recommendations and also appears inconsistent with the role the financial system has in the broader economy. Murray himself seems to acknowledge this point, stating that 'because our terms of reference do not allow us to make recommendations on tax, these observations will flow into the Government's Tax White Paper.'

It is noted in this regard that the publication on 30 March 2015 of the Government's Tax Discussion Paper, titled "Rethink: Better Tax System, Better Australia" highlighted AFMA's concerns. Many of the taxation observations set out in Appendix 2 of the Final Report are either ignored in the Discussion Paper or addressed in a cursory manner. Indeed, ironically, in relation to some issues - such as the effects of interest withholding tax - the Discussion Paper refers back to the Final Report. Hence, there is a disconnect between the approach adopted to taxation matters in the Final Report and the Tax Discussion Paper framework.

AFMA recommendation to Government

We request the Government provide clarity to stakeholders about the appropriate forum to ensure that all observations in Appendix 2 of the Final Report in relation to tax are appropriately consulted upon.

[6] Mr David Murray, AO, *Supporting Australia's Growth,* Committee for Economic Development of Australia, December 8, 2014

5. RESILIENCE

The Final Report's recommendations under the heading of resilience are conditioned on a view that Australia's dependence on imports of foreign capital makes it vulnerable to changes in international investor sentiment. According to the report, 'because of this, it is critical that the Australian financial system is resilient.'[7] The report maintains one of the lessons from the financial crisis is that 'Australia remains susceptible to financial crises, including from dislocation of international markets. A resilient system is required to bolster stability, prevent an increase in moral hazard and reduce risk to taxpayers.'[8]

The Final Report sees Australia's dependence on foreign capital as a key vulnerability, even though the willingness of foreigners to invest in Australia is arguably a vote of confidence in Australia's financial system. The Report does not clearly delineate the types of shock the Australian economy might experience and how these relate to financial system stability. In particular, it is not clear whether the Australian financial system is itself seen as a potential source of shocks or whether the risk of financial instability is seen as a symptom of shocks elsewhere in the Australian or global economy. The Report seems to suggest a risk of foreign capital flight, but this risk is not very informative about how we should regulate the financial system given that capital flight may have many different causes unrelated to the Australian financial system.

To give an obvious counter-point, Japan is a major exporter of capital and has a strongly positive net international investment position. Yet Japan experienced a debilitating financial crisis in the 1990s that left its major financial institutions technically insolvent and has contributed to depressed economic growth for two decades. Being a net importer or exporter of capital does not tell us much about risks or vulnerabilities in the financial system.

Speculative cross-border capital flows are endemic to managed exchange rate regimes, but are not something normally associated with floating exchange rates such as Australia's because the exchange rate serves as a relative price that bears the burden of adjustment to external and even internal shocks. The Final Report's preoccupation with Australia's dependence on foreign capital and the risk of interruption to capital inflows undersells a key strength of Australia's macroeconomic policy framework.

In this context, it is worth noting that during the recent Eurozone sovereign debt crisis, Australian dollar-denominated assets were seen as the beneficiary of safe-haven foreign capital inflows, including increased official sector and central bank reserve holdings of the Australian dollar. This does not suggest foreign investors see the Australian financial system as overly vulnerable to external shocks.

For all the emphasis on Australia's dependence on foreign capital, the report never references foreign direct investment (FDI), a key and relatively stable funding source for domestic investment, nor does it address the barriers to FDI inflows such as the Foreign Acquisitions and Takeovers Act and the Foreign Investment Review Board.

---

[7] Australian Government, *Financial System Inquiry Final Report*, November 2014, 5.

[8] Ibid., 8.

5.1 Capital Adequacy

The Final Report's first recommendation that Australian ADIs should have capital ratios that are 'unquestionably strong' proceeds directly from this preoccupation with the issue of dependence on foreign capital. The report suggests a relative rather than an absolute benchmark for capital adequacy, namely, the top quartile of large internationally active banks against which Australian banks compete for funding in international capital markets. This relative benchmark could be interpreted as a mechanism for preventing Australia from getting ahead of the rest of the world in this particular area of policy. Indeed, Australia is already at the forefront of raising capital adequacy standards globally. But it is a problematic benchmark because of the difficulty of making international comparisons of capital adequacy, as evidenced by the public debate about this issue during the course of the inquiry. As the report notes, there is 'no benchmark of international practice' for comparing capital adequacy.[9] AFMA supports the Final Report's call for the development of harmonised international reporting standards for capital adequacy. Until these measures are developed, there is unlikely to be a widely agreed understanding of Australia's relative international position.

Another potential problem is that capital adequacy standards are still being bedded down globally and will inevitably be subject to changes that will then require Australian regulators to adjust local settings to maintain Australia's relative position. This raises interesting questions. For example, should APRA allow lower capital ratios if international capital adequacy standards are eased for whatever reason? A number of commentators have noted that an absolute rather than a relative benchmark for capital adequacy might be easier for Australian regulators and financial institutions to operationalise in transparent manner.[10]

The report argues for increased capital levels on the basis of a cost-benefit analysis. The benefits of avoiding or minimising financial crises are potentially very large relative to what the Final Report sees as a very modest cost of stronger capital requirements. The costs are assumed to be a 10 basis point increase in lending rates, leading to a 0.01-0.1% reduction in GDP, for every one percentage point increase in capital ratios. It is worth recalling that 0.1% of current price GDP is around $1.6 billion, which would make the recommended increase in capital requirements one of the more costly regulatory imposts on the Australian economy. The report suggests that the increase in interest rates could be offset by the Reserve Bank in its conduct of monetary policy, giving the impression of a free lunch, at least at the macro level. The RBA could equally allow tighter capital adequacy and liquidity standards to substitute for increases in the official cash rate in order to tighten credit conditions. Regardless of any interactions with monetary policy, there are still distributional effects at a micro level, including lower returns to equity for Australian financial institutions

In this context, it is also worth noting that capital ratios had very little predictive power with respect to bank failures in the recent financial crisis. As Peter Boone and Simon Johnson have noted, 'Basel III will end up with capital requirements for systemically important institutions no higher than that

[9] Ibid., 50.

[10] Mike Callaghan, 'Capital levels a domestic not an international concern,' *Lowy Interpreter*, 9 December 2014.

reported by Lehman the day before it failed.'[11] Risk culture was a better predictor, but also harder to regulate.[12] If bank capital ratios are not a good predictor of bank failure and financial crises, then the frequency and cost of financial crises is not a good guide to the costs that should be incurred to strengthen capital requirements.

AFMA Recommendation to Government

AFMA support the Final Report's call for the development of harmonised international reporting standards for capital adequacy.

5.2 Minimum Leverage Ratio

The Final Report proposes a minimum leverage ratio in the range of 3-5% in line with the new Basel framework to serve as a backstop to the risk-weighted capital positions of Australian ADIs. The introduction of a backstop minimum leverage ratio both in Australia and internationally implies a lack of regulator confidence in model-based, risk-weighted capital ratios. This in turn calls into question the investment that has been made in internal models and raises the question of whether simpler approaches to increasing capital ratios might be more robust and transparent. Dowd, for example, suggests a simple leverage ratio based on common equity divided by GAAP-valued unweighted assets.[13]

5.3 Loss Absorbing and Recapitalisation Capacity

The Final Report recommends implementation of a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice to facilitate orderly resolution of Australian ADIs, minimise perceptions of a public guarantee and the need for taxpayer support. The Report has highlighted the fact that such arrangements are being put in place internationally and that Australia 'cannot stand outside international practice' on this issue.[14]

Whereas capital adequacy regulation is about reducing probability of failure, loss absorbing and recapitalisation capacity is about reducing the cost of failure when it occurs by 'bailing-in' creditors (the Final Report proposes to exclude depositors from such arrangements). Essentially, bail-in arrangements convert debt instruments into equity, injecting an additional layer of loss absorbing capacity into a financial institution at the point of failure.

Bail-in arrangements seek to replace implicit or explicit Government guarantees with a system of private penalties and thereby internalise the costs of bank failure. However, this represents a

---

[11] Peter Boone and Simon Johnson, 'The future of banking: is more regulation needed?' *Financial Times*, 10 April 2011, http://www.ft.com/intl/cms/s/0/e0c55688-63b2-11e0-bd7f-00144feab49a.html#axzz3Pajmq5Bu

[12] Simon Samuels, 'A Culture Ratio Is More Important than a Capital One,' *Financial Times*, November 24, 2014, http://www.ft.com/intl/cms/s/0/f44858b8-7169-11e4-b178-00144feabdc0.html

[13] For one critique of model-based approaches, see Kevin Dowd, 'Math Gone Mad: Regulatory Risk Modelling by the Federal Reserve,' *Policy Analysis*, (Washington, DC: Cato Institute, 3 September 2014).

[14] Australian Government, *Financial System Inquiry Final Report*, 69.

transfer of the burden of loss, rather than its elimination. Triggering bail-in arrangements may spare taxpayers at the cost of triggering problems elsewhere in the financial system among the holders of bail-in securities, such as hedge funds or pension funds, that could in turn lead to creditor flight or demands for creditor bail-outs.[15]

The Final Report is not prescriptive about the amount of loss absorbing capacity needed, the type of instruments to be used and how they might be triggered given the prospect or the reality of bank failure. The report also acknowledges that bail-in instruments are relatively new, there is little international experience with their conversion to equity and considerable uncertainty as to the appropriate trigger mechanisms to be used to avoid potential creditor flight. There are also significant issues around the cross-border implementation of recapitalisation and resolution regimes.

Internationally, the FSB and national regulators are imposing total loss absorbing capital (TLAC) requirements of up to 20% of risk-weighted capital on the 30 globally systemically important banks (GSIBs). These banks have begun issuing bail-in securities and the market has already grown to around USD 150 billion in issuance. There is a risk that the demand to hold bail-in securities will come from those less able to monitor or manage credit and equity risk. For example, long-term investors such as pension funds are not well suited to these instruments because they are not in a good position to hedge credit risk (which increases at long horizons). In addition, the concentration of potential losses with a small group of bail-in securities holders will create significant incentives for costly litigation in the event these instruments are triggered.

There is a concern that bail-in securities could become pro-cyclical instruments that worsen rather than ameliorate a crisis. In good times when risks are low, banks will issue bail-in securities and investor demand will drive down yields, encouraging further issuance, enabling banks to expand their balance sheets. However, should a bail-in security convert or be threatened with conversion to equity, this could prompt a wave of selling, bringing forward and spreading a financial crisis from one institution to the rest of the financial system. While bail-in securities may be an effective way of dealing with idiosyncratic bank failure, they may be less effective or make things worse in the context of systemic problems in the financial system.[16]

With these issues in mind, Australian regulators have so far adopted an appropriately cautious approach to bail-in arrangements. Any attempt to mandate increased loss absorbing capacity through bail-in securities in Australia will need to contend with the issues discussed above.

AFMA Recommendation to Government

Australian policymakers and regulators should continue to adopt a cautious stance towards greater use of bail-in securities to increase loss absorbing and recapitalisation capacity and should monitor international experience with these instruments.

---

[15] Charles Goodhart and Emilios Avgouleas, *A Critical Evaluation of Bail-Ins as Bank Recapitalisation Mechanisms*, Discussion Paper 10065 (Centre for Economic Policy Research, July 2014).

[16] Avinash Persaud, *Why Bail-in Securities Are Fool's Gold*, Policy Brief (Washington, DC: Peterson Institute for International Economics, November 2014).

5.5 Direct Borrowing by Superannuation Funds

Recommendation 8 in the Final Report seeks to restore prospectively the general prohibition on direct borrowing by superannuation funds using limited recourse borrowing arrangements (LRBAs) by removing section 67A of the Superannuation Industry (Supervision) Act 1993 (**the SIS Act**), an extension of the original exemption designed to allow super funds to invest in instalment warrants/receipts such as the T1 and T2 securities offered by Telstra. The aim of the proposed prohibition to 'prevent the unnecessary build-up of risk in the superannuation and financial system and to maintain superannuation as a 'savings vehicle, rather than a broader wealth management vehicle.'[17]

5.5.1 Framework for Section 67A

It is noted that Section 67A of the SIS Act was inserted in 2010 with the stated objective of addressing many of the concerns articulated in the Final Report as warranting the repeal of the section. For example, the Final Report states:

> "In a scenario where there has been significant reduction in the in the valuation of an asset that was purchased using a loan, trustees are likely to sell other assets of the fund to repay a lender, particularly if a personal guarantee is involved. As a result, LRBAs are generally unlikely to be effective in limiting losses on one asset from flowing through to other assets."

This comment fails to recognise the particular provisions in Section 67A were specifically enacted to:

- Limit the rights of the lender as against the trustee in the event of a borrowing to rights relating to the acquirable asset, such that no claim against the trustee should arise that could give rise to an indemnity from fund assets (sub-sections 67A(1)(d),(e) and (f);
- Ensure that the rights of the lender or any other person are limited to rights against the acquirable asset (sub-section 67A(1)(d);
- Maintain the requirement that the acquirable assets are held in trust, and are thereby quarantined from other assets of the superannuation fund (sub-section 67(1)(b); and
- Limit borrowing arrangements to a single asset or class of fungible assets so as to prevent borrowing over multiple fund assets.

In AFMA's view, these amendments have ameliorated many of the concerns alluded to in the Final Report as to the basis for the recommended repeal of Section 67A and the Final Report does not provide any views as to the success of the 2010 reforms to the SIS Act. Moreover, to the extent that there are residual concerns as to the success of these reforms in ensuring that the extent to which the borrowings are limited recourse cannot be circumvented, then the appropriate method to address such concerns would appear to be further legislative correction as opposed to the abolition of the entire section.

[17] Australian Government, *Financial System Inquiry Final Report*, 86.

5.5.2 Empirical Evidence

The report notes the rapid growth in LRBAs, but does not otherwise put forward evidence to suggest that this is a threat to the superannuation or financial system or even individual funds in terms of the provision of future income streams in retirement. Indeed, the report concedes 'the level of borrowing is currently small,'[18] a point that is clearly borne out by the statistical evidence, particularly in respect of SMSFs. As at June 2014, the ATO reported that SMSF investment in limited recourse borrowing arrangements such as instalment warrants comprised only 1.57% of total SMSF assets, which was a reduction from the proportion as at June 2013, as set out below:

	June 2013		**June 2014**	
	$m	% SMSF assets	$m	% SMSF assets
Total SMSF assets	495,163	-	557,050	-
Limited recourse borrowing arrangements*	8,314	1.68%	8,735	1.57%
Total borrowings	9,221	1.86%	9,695	1.74%

Source: Self-managed super fund statistical report – June 2014, ATO, September 2014.

* 'Limited recourse borrowings' replaces the 'Derivatives and instalment warrants' SMSF annual return label in prior reports. From 2012–13, the ATO has collected new data on the SMSF annual return relating to assets held under limited recourse borrowing arrangements. These changes to reporting have resulted in adjustments (incorporated above) to estimates for the June 2013 and subsequent quarters.

The ATO report also provides an opportunity to consider the extent to which limited recourse borrowing arrangements are utilised by SMSFs of different sizes and demographics. The highest proportion of SMSF usage of limited recourse borrowing arrangements is a modest 3.16% (SMSFs between $200k - $500K) and is below 1.00% for all demographics below $200K.

In addition, a survey of SMSFs for the Financial Services Council found that only 13% employed leverage in respect of property and 10% in respect of equities. 52% said they were not leveraged. Only 11% reported direct investments in residential property, whether leveraged or unleveraged.[19]

Accordingly, based on available data, the number and value of current SMSF investments in limited recourse borrowing arrangements cannot be seen as posing a systemic risk to Australia's financial system, nor could such a risk be posed in the short to medium term.

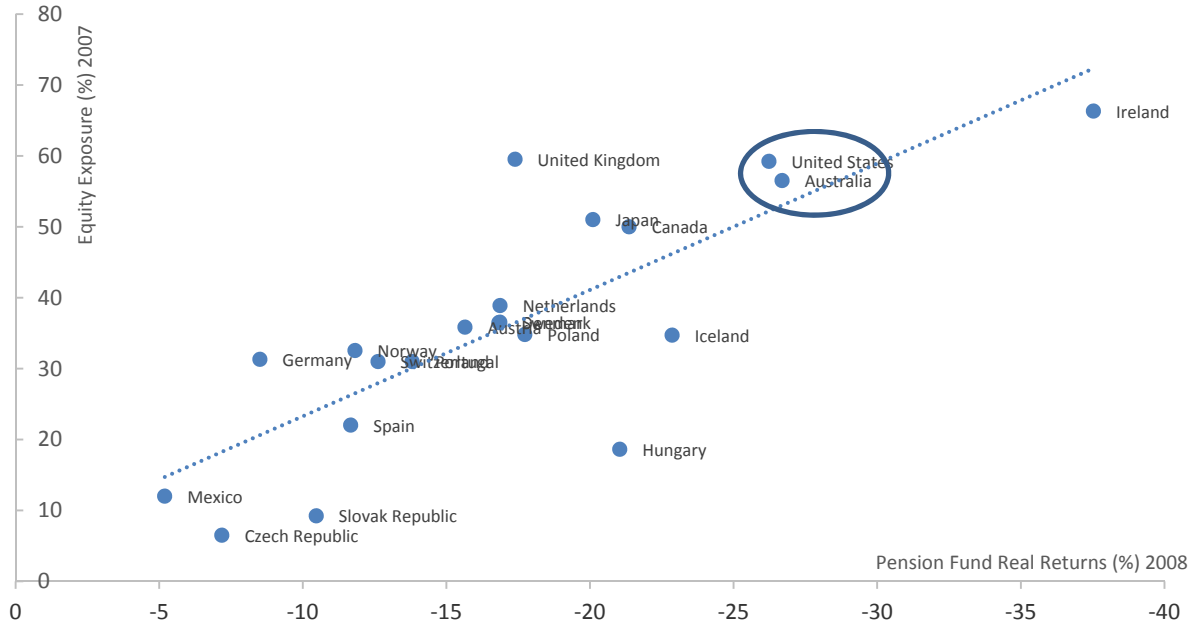
In addition, we do not believe that the current levels of investment in limited recourse borrowing arrangements within funds poses significant risk to Australian retirement incomes.

[18] Ibid., 87–88.

[19] Financial Services Council and UBS, *State of the Industry*, 2014.

The Final Report maintains that the global financial crisis 'highlighted the benefits of Australia's largely unleveraged superannuation system…rapid falls in asset prices and losses in funds were neither amplified nor forced to be realised.'[20] Yet Australia's pension funds experienced some of the worst real returns of any pension system in 2008, second only to Ireland. As Figure 1 shows, real pension fund returns were very similar for Australia and the United States, reflecting a similar level of exposure to equities. This performance is somewhat at odds with the Final Report's observation that the absence of borrowing 'enabled the superannuation system to have a stabilising influence on the broader financial system and the economy during the GFC.' Indeed, the superannuation system was an important mechanism through which the global credit and equity market shock was transmitted to the balance sheets of Australian households.

Figure 1: Pension Fund Real Returns 2008 and Equity Exposure 2007 (Source: OECD)



Source: OECD, Pensions at a Glance, 2009. Dotted line is line of best fit, added by AFMA.

The Final Report maintains that limited recourse borrowing arrangements transfer downside risk to taxpayers through the age pension, but this is true of the superannuation system more generally. Even in the absence of borrowing, prospective retirees can capture the upside of riskier asset allocations, with the taxpayer sharing in any downside through increased age pension eligibility. This may help explain the tendency of Australian super funds to over-weight equities relative to some of their international peers. The demand for riskier asset allocations may come from fund members looking to take advantage of this asymmetry in risk rather than from fund managers.

[20] Australian Government, *Financial System Inquiry Final Report*, 87.

5.5.3 Differentiating limited recourse borrowing arrangements from other geared investments

The Inquiry's Interim Report, in explaining a concern that leverage in superannuation funds could contribute to systemic risk, discussed an example of a fund with directly leveraged exposure to an asset. In the example, if asset prices fell the fund would have to post additional margins, potentially forcing asset sales, triggering further price falls and possible spill-over to other parts of the financial system. The Interim Report notes its concern that such events could put retirement incomes at risk.

In the Final Report, a different example scenario was used to express the same or similar concern about contagion to other fund assets. In this scenario, if there was a significant reduction in the valuation of an asset that was purchased using a loan, the Inquiry panel expect that trustees are likely to sell other assets of the fund to repay the lender, "particularly if a personal guarantee is involved".

In considering what (if any) systemic risk or risk to retirement incomes might be posed by leveraged investment by SMSFs, and particularly in respect of limited recourse borrowing arrangements, it is important to consider and distinguish between different forms of leverage and the difference in risk that attaches to each.

The example in the Interim Report appears to relate to a margin lending arrangement, which would typically involve a loan with full recourse to the assets of the borrower (therefore precluding superannuation fund investment in any case), or perhaps a contract for difference. The example in the Final Report involving a personal guarantee may relate to a superannuation fund making a leveraged investment in, for example, real property.

In contrast, limited recourse loans used to purchase listed/widely-held products (such as the loan available under an instalment warrant):

- do not require any additional margins to be posted if asset prices fall;
- do not result in forced sales of the underlying products or any other fund assets to meet margin calls; and
- do not encumber other assets of the SMSF. In the case of instalment warrants over listed products, recourse under the loan is limited to the underlying products and no personal guarantees are given to further secure the loan amount. Recourse is limited by either a notional or an explicit put option packaged together with the underlying listed products and the loan. Part of the prepaid interest on the instalment warrant loan is treated as the cost of capital protection under the notional put option, as required by the capital protected borrowing provisions of the tax legislation.

It was intended that the risk to other superannuation fund assets arising from the provision of personal guarantees to underwrite the lender's risk under a limited recourse borrowing arrangement would be addressed by legislative amendments in 2010 which inserted s67A of the *Superannuation Industry (Supervision) Act 1993* (see page 9 of the explanatory memorandum to the *Superannuation Industry (Supervision) Amendment Act 2010*). To address the Inquiry panel's concern that some lenders continue to require personal guarantees to secure borrowing arrangements

offered to superannuation funds, enhanced supervision and enforcement of s67A may be necessary. In our view, such targeted supervisory action should be preferred to prohibition of true limited recourse borrowing arrangements which do not put other superannuation fund assets at risk.

A further point of contrast with the Inquiry panel's examples is that the risk of excessive concentration of superannuation in a single asset may be increasingly prevalent in the case of leveraged SMSF investment in real property or a small business, but it is a remote prospect in the case of limited recourse loans used by SMSFs to purchase listed/widely-held products.

5.5.4 Funds can obtain leverage without borrowing

Geared equity investments are readily available through existing superannuation platforms and the assets purchased by funds may themselves be leveraged even if the fund itself does not borrow. The Final Report does not offer a compelling rationale for limiting direct borrowing by superannuation funds.

Indeed, the genesis for the initial inclusion in Section 67 of the SIS Act to allow a superannuation entity to invest in instalment warrants was that such warrants were economically fungible with instalment receipts, but involved a discrete borrowing. A repeal of Section 67A will, in our view, merely cause product providers to revert to instalment receipt structures.

Aside from instalment warrants, other forms of leverage in superannuation fund investments include for example:

- Contracts for difference and margin foreign exchange contracts, which offer up to 20 times leverage on contracts over highly liquid stocks, 100 times leverage on major indices and 500 times leverage on popular currency pairs. Such investments can embed substantially more leverage and risk to capital than limited recourse loans and investors may lose more than their initial margin posted on a position (e.g. severe margin forex losses that followed the Swiss National Bank's decision to remove its cap on the EUR-CHF exchange rate);
- Derivatives, such as options and futures which offer embedded leverage;
- Hedge funds or other leveraged managed investment schemes, which offer indirect leverage (typically to shares) at varying leverage ratios and may use derivatives. Such investments may offer more or less leverage than an investment in instalment warrants. Investors pay ongoing management fees and do not have control over the investment decisions of the managed fund;
- Listed investment companies, which may be leveraged;
- Structured investment products, which may have embedded leverage and carry risk exposure akin to a derivative;
- Real estate investment trusts, which offer indirectly leveraged exposure to commercial, agricultural or residential real property;
- Real property (direct investment) - where this is geared it will expose the SMSF to a concentrated exposure to an illiquid asset within the SMSF investment portfolio. We note

that several submissions to the Financial System Inquiry specifically raised concerns about direct investment in real property by superannuation funds using borrowings; and

- Shares in companies which may be highly leveraged e.g. speculative small-cap companies.

It can be argued that the direct borrowing provided by products such as instalment warrants is preferable to these other means of achieving investment leverage because under an instalment warrant there is a greater degree of transparency and control as to the amount of leverage in the investment and its underlying assets. Also, instalment warrants may be used to limit downside market risk of an equity investment given the limited recourse nature of the borrowing.

To give a simple hypothetical example, an SMSF trustee allocates $50,000 to invest in the shares of a particular Australian listed company and considers whether to (a) directly purchase $50,000 worth of shares in the company, or (b) buy instalment warrants with a leverage ratio of 60% that give a $50,000 exposure to the same shares for a total purchase price (including prepaid interest cost) of $21,550 and invest the remaining $28,450 in a bank term deposit. Because the instalment warrant loan is limited recourse, if the company becomes insolvent and its share price declines to $0, the trustee's loss will be limited to the purchase price of the instalment warrants ($21,550), not the entire $50,000 if invested directly in the shares.

Leverage (in its many forms) is but one type of risk that may affect Australians' superannuation investments and resulting future retirement incomes. A SMSF trustee takes on responsibility for investing their superannuation funds and for managing the risks of those investments. The rules governing SMSF investment decisions and the management of risk are predominantly principles-based and do not expressly prohibit a SMSF trustee from entering into an investment that gives rise to concentration risk, market risk, credit risk or liquidity risk (or many other risks).

As discussed above, the available data on superannuation borrowings does not demonstrate a systemic risk or significant risk to retirement incomes that would provide rationale for imposing restrictions on superannuation fund leverage. However, if the Government determines otherwise, in our view, any policy settings that seek to restrict investment leverage in superannuation funds should be principles-based and consistently applied across financial product types, except where the nature or experience of a particular product type is such that product-specific restrictions are deemed necessary to protect fund members from excessive risk of loss. Other than in those circumstances, any superannuation investment restrictions which single out specific investment types or strategies will risk creating an uneven playing field and will potentially add further distortion and bias to superannuation investment decisions.

5.5.5 Suitability of leverage for superannuation funds through enhanced advisory standards

An ancillary reason cited by the Inquiry panel's Interim Report for considering the policy option to prohibit direct leverage of superannuation funds is its concern about the risks to Australian superannuation assets and retirement incomes from poor quality and conflicted financial product advice from financial advisers and accountants (both in respect of leveraged and unleveraged investments).

The Interim Report cites the example of an ASIC review of over 100 advice files identified as "high risk" that contained recommendations to clients with superannuation balances of less than $150,000

to establish a SMSF. ASIC's review is detailed in ASIC Report 337. ASIC's review of these selected advice files from 18 entities found 'pockets of poor advice', mostly recommending the establishment of an SMSF to gear into real property. Of the advice files ASIC reviewed that recommended borrowing, 98% related to investment in real property.

In response to events leading to the collapse of Storm Financial and the leveraged losses suffered by its advice clients, the Future of Financial Advice (FOFA) reforms were implemented to strengthen protections against conflicted advice. These reforms have come into force since the ASIC review of SMSF advice in 2012. Most relevantly, in the context of discussion of leveraged investments, the FOFA reforms introduced a ban on financial services licensees charging an asset-based fee on a borrowed amount (such as the loan amount under an instalment warrant). In the short time that has passed since the implementation of this and other FOFA reforms, such as the conflicted remuneration provisions, it is difficult to fully assess the impact the reforms have had on the quality of advice concerning leveraged investments. However, the FOFA reforms and related consumer protections afforded by Chapter 7 of the Corporations Act 2001 do not apply to unregulated advice regarding leveraged investment in real property. Leveraged investment in real property appears to be central to the Inquiry panel's concern about direct borrowings by superannuation funds.

In its Final Report the Inquiry panel considered whether the appropriate policy settings for financial product advice are in place and recommended a number of measures intended to improve consumer outcomes. In our view, appropriate policy options should directly target the problem of poor quality and conflicted financial product advice. We do not believe that a blanket prohibition on particular investment strategies or investment products is necessary or appropriately targeted to respond to their misapplication and misuse by a segment of 'bad apple' financial advisers who fail to act in their client's best interests, or worse seek to defraud clients for their own enrichment.

5.5.6 Asset alignment to taxation measures

The Government has released an Exposure Draft that, once enacted, will provide certainty as to the taxation treatment of holders of instalment warrants and instalment receipts. These measures will ensure that the holder of an instalment warrant or instalment receipt is treated as the beneficial holder of the underlying asset, which provides certainty as to capital gains tax and franking outcomes. Importantly, the Bill will limit the classes of assets to which taxation certainty is provided to listed and widely-held shares and units. That is, an instalment warrant or instalment receipt over, for example, residential property, will not be caught by the proposed measures. We see merit in aligning the asset class requirement under the proposed taxation measure to the Government's response to the recommendation of the Final Report, such that Section 67A is preserved but is only available to the extent that the limited recourse borrowing is in respect of listed and widely held shares or units.

Such a policy response will, in our view, ensure that limited recourse borrowing arrangements are consistent with the initial policy intention of Section 67A and effectively eliminate the concerns articulated in the Final Report regarding personal guarantees and borrowings over other asset classes not being truly "limited recourse."

AFMA Recommendation to Government

The Government should retain Section 67A of the *Superannuation Industry Supervision Act*, in respect of limited recourse borrowings to acquire listed and widely held assets or units, as defined in the taxation legislation. Such an amendment would reinstate the initial policy intention of allowing superannuation entities to borrow on a limited recourse basis to invest in instalment warrants.

The amendment may be easily done through an amendment to the definition of "acquirable asset" in section 67A(2) to include a listed or widely held share or unit, applying the same legislative construction as used in the taxation legislation.

6. REGULATORY ARCHITECTURE

The Final Report does not call for significant changes to the regulatory architecture for the Australian financial system. However, it does make recommendations for new regulator accountability arrangements and a new funding model for ASIC that require careful consideration by Government, particularly given the possibly quite substantial impact on industry of changes to the funding structure.

6.1 Financial Regulator Assessment Board

Recommendation 27 of the Final Report is for a new Financial Regulator Assessment Board (FRAB) 'to conduct annual performance reviews of regulators and provide advice to Government'.[21] The Board's mandate would cover ASIC, APRA and the payments system functions of the Reserve Bank, although the report also suggests that AUSTRAC should be considered for inclusion, something AFMA would support.[22] The Board would not review regulator mandates or the frameworks they administer.

The FRAB would replace the Financial Sector Advisory Council (FSAC), a non-statutory body created following a recommendation of the Wallis inquiry. FSAC has a very different mandate 'to provide advice to the Government on policies to facilitate the growth of a strong and competitive financial sector' and it is not clear why it is thought necessary to replace FSAC. Indeed, a notable omission from the Final Report is a new advisory and coordinating body that might bring together industry and Government and champion the financial sector at a political level. A revamped and revitalised FSAC or similar body was a recommendation of many stakeholder submissions to the inquiry.

The proposed FRAB reviews are characterised as 'annual ex post reviews of overall regulator performance against their mandates' and statements of intent,[23] 'including on how regulators consider competition issues in designing and implementing regulation.'[24] It is also envisaged the board will assess the use of the proposed new product intervention powers for ASIC.

The Final Report characterises the assessments as follows: 'The reports would consider how the regulators have balanced the different components of their mandates as well as how they are allocating resources and responding to strategic challenges. Reports should include the views of regulators and be made public once Government has had the opportunity to consider a response.'[25]

Annual reviews by the Assessment Board would be broader than the process envisaged under the Regulator Performance Framework the Government has already introduced and which is due to commence from the middle of 2015. Under the Regulator Performance Framework, regulators will need to undertake annual, externally-validated, self-assessments of their performance with a view

[21] Australian Government, *Financial System Inquiry Final Report*, 29.
[22] Ibid., 245.
[23] Ibid., 235.
[24] Ibid., 19.
[25] Ibid., 239.

to minimising their burden on the regulated population. Selected regulators will also have their performance assessed externally by a review panel every three years, with the option of an annual review for major regulators.

To avoid duplication, the Final Report suggests the Financial Regulation Assessment Board could act as the validation body for each regulator's annual self-assessment, but this raises the question as to what extent the annual reviews by the proposed new Board will go beyond those already provided for under the Regulator Performance Framework.

It is not intended that the Assessment Board should direct the regulators — it would report to Government. It would also be precluded from examining individual complaints against regulators or the merits of particular regulatory or enforcement decisions and the merits of relief for particular transactions. However, it would be asked to assess how regulators have used the powers and discretions available to them.

The Board would consist of between five and seven part-time members with industry and regulatory expertise, excluding current employees of regulated entities. The board would not be a separate agency and would be supported by a secretariat within Treasury.

6.1.1 Differences with the AFMA IGOR Proposal

The proposed Financial Regulator Assessment Board has a similar mandate and functions to AFMA's proposal for an Inspector-General of Regulation modelled on the 2003 Uhrig review's recommendation and the existing Inspector-General of Taxation.[26] AFMA's proposal recognises the importance of enhanced accountability arrangements given that regulators are seeking new powers and increased operational and budgetary independence from Government. There are several important differences between the two models:

1. An IGOR could be expected to be more independent than a process embedded in Treasury.

2. The Board is seen reporting to Government, with Government responding on behalf of regulators. As an independent statutory agency, an IGOR would report to Parliament in the first instance, with regulators responding to reports on their own behalf.

3. An IGOR would not be as reliant on regulators' self-assessment processes. The danger with the Board as proposed is that it becomes a rubber-stamp for these self-assessment processes, rather than a source of rigorous independent scrutiny.

4. An IGOR would have a stronger capacity to set a flexible work program to address specific issues to its own timetable, whereas the Regulator Performance Framework and the FRAB might be overly structured and inflexible in their approach.

5. An IGOR would be open to taking up issues brought to it by the regulated community that could not be raised in other contexts because of fear of adverse treatment by Government or

[26] Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders*, June 2003.

regulators. The FRAB proposal does not offer an explicit mechanism by which the regulated community could raise issues free from such concerns, although it could be structured to include such a mechanism.

6. An IGOR would have powers to compel documents and evidence, whereas it is not clear that a FRAB would have similar powers in the absence of a MOU governing information sharing between regulators and the Board.

7. The Final Report's main criticism of the IGOR model it creates a new agency. The IGOR model is also criticised as creating too much reliance on a 'single person.'[27] So the IGOR model is seemingly criticised for being both too big and too small. This raises questions about whether a FRAB would be adequately resourced to perform its functions if it is not an agency in its own right, especially given that Treasury is already over-stretched in terms of resourcing. It should be noted that agency size and budget have not been raised as significant issues for the effectiveness of either the Inspector-General of Taxation or the Inspector-General of Intelligence and Security. The effectiveness of these bodies is more a function of their powers than their size or budget. An independent oversight body with significant powers is potentially an important discipline on regulators.

AFMA Recommendation to Government

AFMA remains of the view, for the reasons set out above, that establishment of an IGOR is the better approach and, indeed, the necessary approach to produce more effective regulation and enhanced financial service outcomes in the longer term. The establishment of either an IGOR (or FRAB) will necessitate giving appropriate powers to either body along with resourcing and other administrative arrangements. Any perceived bureaucracy issues are outweighed, in AFMA's view by the benefits that a robust oversight process could produce for the financial sector.

In the context of the proposals in the Final Report about regulator funding, a robust independent process to oversight how regulators perform their functions is a critical tool in ensuring full accountability and transparency in the utilisation of regulator resources, including whether those resources are being deployed to the activities that pose the most risk to the proper functioning of the financial sector. The Government's core policy of red tape reduction and removal of unnecessary compliance burden will be jeopardised in the absence of effective tools that enable close monitoring of resource allocation by regulators.

If the Government decides that an IGOR is not appropriate, AFMA supports the introduction of a Financial Regulator Assessment Board as a starting point for an improved system of regulator accountability and oversight. AFMA also supports the inclusion of AUSTRAC within the scope of the Board's responsibilities. However, careful attention will need to be given to the Board's independence from Government, the flexibility of its work program, its powers to compel documents and evidence and the creation of mechanisms that would allow the regulated community to raise issues with the Board without prejudice. Consideration will also need to be given

[27] Australian Government, *Financial System Inquiry Final Report*, 243.

to how the Board's oversight will complement and work with existing accountability mechanisms, such as the parliamentary committee system.

6.2 ASIC Funding

Under the heading of 'strengthening Australian Securities Investment Commission's funding and powers,' the Final Report proposes an 'industry funding model', although only offers very general principles as to how such a model should be applied.[28]

The report argues that the absence of industry funding means ASIC costs are not transparent to regulated industry participants. It also contends that the current funding model 'exposes ASIC to an increased risk of funding cuts that are unrelated to changes in the cost of delivering on its mandate.' The report argues 'the main benefit of industry funding is its potential to give ASIC more predictable funding as well as strengthen engagement between ASIC and industry on the costs of conduct and market regulation.'[29]

AFMA understands that ASIC has undertaken modelling work on a funding proposal, but this information is not publicly available at this time. It is therefore not possible to make informed comment about the advantages/disadvantages of any particular model that may have been put forward for consideration. Accordingly, AFMA's comments relate to the principles that should govern industry funding and the accountability framework that must be in place to provide transparency and confidence about the implementation and administration of this kind of funding model. This framework does not currently exist in any substantive way and must be established before any transition to industry funding commences.

Certainty of funding for regulators is widely acknowledge as an issue, particularly as ASIC has been given increased responsibilities and powers. Implicit in the Final Report's recommendation for an industry funding model is an assumption that this will increase the resources available to ASIC. By implication, the Final Report seems to be suggesting that ASIC will receive a larger appropriation from Government under an industry funding model than under the current model. This may reflect an assumption that since Government will no longer bear the budgetary burden of an increased appropriation, it will be more willing to approve a larger appropriation. This poses a moral hazard issue for Government that needs to be addressed through appropriate accountability and oversight mechanisms. As independent academic observers such as Maddock *et al* have noted:

> *Some regulators have proposed that their regulatory activities should be funded by a levy on the parties being regulated, by licence fees or similar industry charges. This should be resisted. It reduces the degree of budgetary scrutiny on the agency and undermines a key lever for regulatory accountability. Rather than having to fight for an allocation in the budget*

[28] Ibid., 250.
[29] Ibid., 253.

> *process, justifying spending to an expenditure review committee, a regulator funded by an industry levy is taxing the parties that it is regulating*.[30]

The recommendation to move to an industry funding model points to a confusion between the issue of the size and predictability of ASIC's appropriation from Government and how this appropriation should be funded. The fact that successive Governments have not provided ASIC with sufficient budgetary predictability or certainty does not in itself establish the case for industry funding. Rather, it argues for better prioritisation and administration of Government expenditure. The Final Report proposes three-year funding agreements for regulators to provide greater budgetary certainty (AFMA has argued for even longer term five-year funding agreements). In principle, such funding agreements can solve the budget predictability issue without changing the source of ASIC's funding from the taxpayer to industry. The case for industry funding needs to rest on something more than the need for greater budgetary certainty.

The Final Report's contention that industry funding increases transparency and engagement between industry and the regulator overlooks significant risks associated with this change in the relationship between the regulator and the regulated community. As Maddock *et al* note:

> *Requiring the regulated businesses to fund the regulator might seem appealing in that the parties 'using' the regulation are paying for it. But the structure means that regulated parties have very little incentive to complain about excessive charging or laxness by the regulator. They may indeed feel intimidated. It sets up a 'customer-provider' relationship between the regulator and the parties it is regulating, while at the same time reducing the accountability of the regulator to its actual principal – the Parliament. Put simply, it creates the wrong incentives*.[31]

Even where regulator costs are made more transparent to industry, there is currently no mechanism through which industry can impose discipline on regulator costs and the associated burden of an industry funding model. Only Parliament can impose the necessary degree of oversight and scrutiny to effectively discipline regulator expenses, but industry funding weakens its incentive to do so.

For industry funding models to be economically efficient, the regulatory cost burden should fall on the ultimate beneficiaries of regulation. In the case of ASIC, the beneficiaries are for the most part the consumers of financial services rather than producers. The rationale for levying industry depends on the assumption that industry can pass these costs on to consumers. However, both the attribution of regulator costs to regulated institutions and activities and the subsequent pass through to consumers is necessarily very imperfect. Moreover, there is a significant public benefit to regulation that is very difficult to embody in industry funding models, as opposed to taxpayer funding models. The practice in Australia has been to ignore this public good aspect of regulation in designing cost recovery models on the basis of administrative convenience. However, for cost recovery to be economically efficient, a mix of public and industry funding is arguably called for. A mixed funding model retains the Government's budgetary skin in the game, maintaining incentives for Government and Parliamentary scrutiny of regulator costs.

---

[30] Rodney Maddock, Joe Dimasi, and Stephen King, *Rationalising Rustic Regulators: How Should Australia's National Economic Regulators Be Reorganised?*, n.d., 19–20.

[31] Ibid.

In AFMA's view, any shift to an industry funding model for ASIC requires a stronger accountability framework to ensure appropriate incentives for regulators to maintain efficient costs and for Government to exercise an appropriate level of scrutiny of regulator budgets and activities. The Final Report's proposed Financial Regulator Assessment Board contains some of the elements of such a framework, but needs to be fleshed out to include some of the elements of the Inspector-General of Regulation model discussed above.

In its first round submission to the Inquiry, ASIC claimed that a user pays funding model will generate price signals that will encourage self-regulation or co-regulation where the pre-conditions for such models exist as an alternative to regulation by ASIC. However, these pre-conditions are absent for much of ASIC's regulatory activities. For the most part, ASIC-regulated entities do not have the choice of self or co-regulation as an alternative to current arrangements. Indeed, ASIC would have a strong incentive to disallow or lobby against such self-regulatory models if it were industry funded. ASIC's argument in this regard is akin to APRA arguing that cost recovery would generate price signals that would lead to self-regulated, unlicensed banks, which are an impossibility under Australian law.

ASIC similarly maintain that a lack of pricing may lead to over-use of its services compared to other more costly alternatives, for example, private legal advice. Yet it would seem unlikely that ASIC's services have many close substitutes provided by the private sector. Moreover, ASIC can charge user fees for these specific services without having to adopt a cost recovery model for its other regulatory activities for which there is a stronger case for taxpayer funding. Indeed, ASIC already raises revenue in excess of its appropriation from Government, but this revenue in excess of the annual appropriation is already budgeted for other expenditures.

AFMA Recommendation to Government

AFMA supports the Government entering into long-term funding agreements with ASIC and other regulators to provide more predictability and certainty in Government funding. However, AFMA believes that this can be achieved without a change to an industry funding model. If an industry funding model is to be adopted, careful attention will need to be given to the mapping of ASIC's regulatory costs on to regulated entities and activities to ensure an equitable and proportionate burden on industry. The burden of cost recovery should fall on fee for service arrangements rather than on regulatory activities that have the characteristics of a public good. Cost recovery arrangements need to take account of the full range of costs and public and private benefits arising from the regulated activity and the overall burden being imposed on industry through other cost recovery arrangements, be they existing or proposed. AFMA is disappointed about the lack of regard for, or even awareness of, the quantum effects of cost recovery arrangements on industry where participants are paying multiple levies in relation to different regulators.

7. CONSUMER OUTCOMES

7.1 Introductory Comments

Enhancing consumer outcomes is a significant focus of the Inquiry and the Final Report looks to build on other developments by both Government and industry to improve consumer outcomes, such as the Future of Financial Advice reforms, the recent Parliamentary inquiries into the performance of ASIC and into lifting the professional, ethical and education standards in the financial services industry and industry consultation on the design of a register for financial advisers. However, the Final Report notes that its recommendations are broader than such developments and that it 'would be a mistake to look at our recommendations in this area through the narrow lens of the recent debate on FOFA.'[32]

Against this backdrop, the Final Report has articulated a set of principles that guide the recommendations in enhancing consumer outcomes. These are as follows:

- An acknowledgement that a fair financial system will allow consumers to take on risk in order to make a return, and that any assumption of risk may lead to losses arising from market movements;
- In order to allow consumers to accept responsibility for their financial decisions, it is necessary that:
    - Consumers should receive fair treatment;
    - Consumers should have access to competent, good quality financial advice;
    - Information provided to consumers should be accessible, engaging and understandable;
    - Financial literacy standards are an important part of the consumer framework;
- Product issuers and distributors should take responsibility for the design, targeting and distribution of financial products;
- ASIC should be proactive in its supervision and enforcement; and
- Consumers should have access to timely and low-cost dispute resolution.

7.2 Design and Distribution Obligation

It is apparent from the principles set out above that the Final Report is seeking to promote a paradigm whereby consumers are properly equipped to take responsibility for their investment decisions and hence bear the burden of any losses that may arise, where such a loss was not due to behaviour outside the principles set out above. The first recommendation to bolster the robustness

[32] Mr David Murray, AO, *Supporting Australia's Growth,* Committee for Economic Development of Australia, December 8, 2014.

of the consumer framework deals with the distribution side of the framework, and states that the Government should 'introduce a targeted and principles-based product design and distribution obligation.[33]'

This recommendation would impose upon those responsible for the formulation of the product an obligation to consider not just the commercial considerations associated with the product but also the type of consumer most suited to the product and the most appropriate delivery channel for that product.

7.2.1 Basis for the recommendation in the Final Report

The current regulatory framework relies heavily on disclosure, financial advice and financial literacy, of which only the former is the responsibility of the product provider[34]. However, the Final Report notes that 'disclosure can be ineffective for a number of reasons, including consumer disengagement, complexity of documents and products, behavioural biases, misaligned interests and low financial literacy.'[35] Accordingly, the recommendation is looking to build on recent FOFA reforms to improve consumer outcomes from the perspective of product providers.

It is noted that certain industry segments have sought to self-impose higher standards on the distribution process to ensure that products are targeted to the most suitable consumers. AFMA itself produces 'Principles Relating to Product Approval'[36] for retail structured finance products which, amongst other things, encourages product providers to ensure that:

- New financial products are subject to a robust internal approval process and sign-off;
- Such approval is in light of a documented approval framework which addresses:
    - Reputational risk;
    - Roles and responsibilities for those engaged in the approval process;
    - Product suitability;
    - Conflict management;
    - Potential changes in the external environment and implications arising;
- Firms should only offer a product that represents a genuine investment opportunity for investors, although still subject to risks;
- Product suitability for the targeted market segment should be considered at the product design stage;
- Products should be the subject of appropriate taxation review and advice (where appropriate), with consideration given to obtaining an ATO Product Ruling; and

[33] Australian Government, *Financial System Inquiry Final Report*, November 2014, 198

[34] Depending on the structure of the business, some integrated firms also provide financial advice.

[35] Australian Government, *Financial System Inquiry Final Report*, November 2014, 199

[36] http://www.afma.com.au/afmawr/_assets/main/lib90032/product%20approval%20principles.pdf

- The product should satisfy genuine client interests and enhance the provider's relationship with its investors.

The Final Report positively cites these principles, but notes that they do not cover all issuers and are not enforceable.

7.2.2 Design of the Obligation

In framing the recommendation, the Final Report is conscious of concerns from industry stakeholders that regulatory intervention at the distribution stage could increase product costs or decrease product offerings for consumers. Given the observation that many firms have already enhanced protocols for product approval, the recommendation seeks to build on such enhancement, and thereby mitigate implementation costs, by building on good practice, being principles based and applied on a scale basis, allowing scope for firms to builds on existing protocols.[37]

7.2.3 Alternative Solutions

It is noted that the FSI Panel considered other options to bolster the consumer framework through enhancing suitability of products for investors. Such options included:

- An individual product appropriateness test, whereby an issuer would need to undertake an assessment of the individual's circumstances before making the product available to them – this was ultimately not recommended given the increase in costs for issuers, particularly where the issuers are not the providers of advice to the individual; and
- An entirely self-regulatory approach, through making the AFMA product approval principles more pervasive and relying on the financial services industry to monitor how standards are applied and take necessary disciplinary action – however the Final Report ultimately took the view that past industry-led standards had not been sufficient, by themselves, to address serious conduct issues.

In relation to the second point, AFMA has always acknowledged the limitations of our product approval principles and particularly that they do not apply to non-members, albeit that they are freely available to non-members.

AFMA's Principles Relating to Product Approval recommend that a product issuer should conduct a "know your distributor" process[38]. Matters which should be considered include:

[37] Australian Government, *Financial System Inquiry Final Report*, November 2014, 202

[38] See section G - Distribution

- the distributor's business (the sales team and their experience selling structured products), size (capacity to implement the distribution strategy) and reputation;
- sales practices and use of marketing materials;
- whether the distributor provides any advice, general advice or personal advice to the relevant investors;
- the distributor's typical client type, and whether the distributor deals directly with the client, or via other intermediaries;
- where a distributor introduces investors to the product at seminars or through advertisements, whether those measures are appropriate for the target market and the product being offered;
- whether the distributor considers the suitability of a financial product on an individual investor basis or for a class of investor;
- the distributor's regulatory status and reputation; and
- any history of complaints against the distributor or other information that is relevant to the good standing of the distributor, to the extent this information can be obtained; and
- whether the distributor has arrangements in place so that its representatives have sufficient knowledge and understanding of the product to be able to give appropriate advice to investors.

The Principles also recommend ongoing review of distribution arrangements and taking any necessary action which could include:

- amending consumer or adviser literature;
- providing additional training for distributors;
- limiting distribution to specific channels;
- ceasing to use a particular distribution channel; and/or
- escalating issues to senior management of the issuer.

All of the above measures are based on the product issuer undertaking best endeavours to mitigate as far as possible the risk that its product will be distributed to an investor or class of investors for whom the product is not appropriate. However, as a matter of law, it is the licensee who provides advice to a client who that has the obligation to ensure that they are acting in the best interest of that client. That obligation cannot be conferred on the product issuer who, in many cases, has no relationship with the client until after the client acquires the product. In short, the behaviour of a distributor in giving advice to clients remains the responsibility of that person/entity as the holder of a financial services license.

AFMA recommendation to Government

Any legislative obligation in relation to product design and distribution will need to recognise the existing statutory roles and responsibilities of product issuers compared to licensees who provide financial advice to retail consumers.

7.3 Aligning Interests of Firms and Consumers

In addition to expanding the obligations of issuers and distributors with respect product suitability, the Final Report seeks to raise what it perceives to be poor standards of conduct and professionalism in the industry, with the goal of ensuring that organisational cultures are aligned with consumer interests. With this in mind, the Final Report recommends that Government:

> 'better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.'[39]

7.3.1 Raising Industry Standards

The first aspect of the recommendation is to raise industry standards - that is, improving the culture of financial firms' management so as to promote trust and confidence in the financial system. The recommendation is aspirational, and the Final Report does not provide any views or perspectives as to how this ought to occur, apart from suggesting that 'industry associations could lead this initiative, with stakeholder input from ASIC and consumer organisations,'[40] such as through enhanced Codes of Conduct.

7.3.2 Enhanced Banning Power

The catalyst for the second part of the recommendation, namely the enhanced banning power, is to address what ASIC has described as 'phoenix activity,' whereby people within an organisation who breach professional standards merely establish new businesses or move to alternate firms. Under its existing regulatory toolkit, ASIC is able to prevent a person from providing financial service, but not managing a financial firm. By extending the banning power, the Final Report perceives that there should be an improvement in professional behaviour and an improvement to the industry generally.

AFMA Recommendation to Government

In its submission to the Interim Report, AFMA noted that it had 'no objection to enhancement of ASIC's powers to include banning individuals from managing a financial services business, subject to the normal procedural fairness issues and natural justice.'[41]

[39] Australian Government, *Financial System Inquiry Final Report*, November 2014, 217

[40] Australian Government, *Financial System Inquiry Final Report*, November 2014, 220

[41] AFMA, Submission to the Financial System Inquiry Interim Report, 26 August 2014, 42

7.3.3 Remuneration Structures

The Final Report takes particular aim at two segments of the financial services industry and the remuneration structures prevalent in such segments: life insurance and stockbroking. While the particular issues with each segment are slightly different, broadly the Final Report is aligning itself with recent FOFA reforms by taking umbrage with commissions.

For stockbrokers, the Final Report refers to 'grid' commissions, whereby the value of a stockbroker's commission for a particular transaction is a function both of the total commission payable on the transaction and the total commission generated by the broker annually. Based on a usual grid, the higher that these two factors are, the greater proportion of the brokerage payable on a trade returned to the broker as commission. The concern that the Final Report articulates with respect to 'grid' remuneration structures is that such structures create 'the potential for a conflict of interest between the adviser and the consumer.'[42] The Final Report advocates a review of current remuneration structures in the stockbroking industry and further Government intervention if warranted, potentially to intervene to align the remuneration structures for Australian brokers with international examples, which generally involve a fixed salary plus a discretionary bonus.

It is noted that the observations made by the Final Report regarding remuneration structures for stockbrokers have not gone unchallenged. The Stockbrokers Association of Australia stated that 'existing arrangements for stockbroker remuneration do not present any risk of being conflicted remuneration' (under FOFA) as 'these arrangements are product neutral and do not pose any risk of one product being recommended as opposed to another.'[43]

From AFMA's perspective, the issue is also about the sustainability of the grid structure for remuneration in the face of commercial imperatives, such as continued downward pressure on revenue and lower trading volumes, as opposed to whether the grid structure results in a misalignment of incentives of brokers vis-à-vis their clients.

Financial services licensees, including stockbrokers, have undertaken substantial review and change where needed of their incentives and remuneration structures to ensure that their arrangements are fully FOFA compliant. It is not clear on what basis a further review of those arrangements is required.

[42] Australian Government, *Financial System Inquiry Final Report*, November 2014, 219

[43] Stockbrokers Association of Australia, Media Release, *Stockbrokers Association Takes Issue with Financial System Inquiry Comments on Stockbroking Remuneration*, 8 December 2014.

7.4 Raise the Competency of Advisers

The final recommendation in relation to improving the consumer framework is to raise the standards of adviser competence. The Final Report recommends that the Government:

'raise the standards of financial advice providers and introduce an enhanced register of advisers.'

This recommendation is largely uncontentious and builds upon recent efforts by Government and industry to improve adviser standards both via Parliamentary committee and also working groups convened by the Government. AFMA notes the recent announcement by the Assistant Treasurer of the Government's intention to conduct public consultation about a professional competency framework for financial advisers who provide advice on Tier 1 products to retail customers.

7.4.1 Current Adviser Competence Regime

A recurrent theme in both the Interim Report and the Final Report is that affordable, quality financial advice can bring significant benefits for consumers. This relies on those providing the advice attaining a satisfactory level of competence to provide such financial advice. In this regard, the Final Report agrees with the statement made by the PJCFFS that 'licensees' minimum training standards for advisers are too low, particularly given the complexity of many financial products.'[44]

Adviser standards of competence are currently set out in ASIC guidance, with the standards varying based on the complexity of the financial products being advised upon.[45] Stakeholder submissions, such as those provided by AFMA, called for a more robust framework for assessing adviser competence in a manner consistent with other professions. This framework may include:

- Minimum education requirements in order to gain entry into the profession, with appropriate transition to advisers holding tertiary qualifications as a pre-requisite to employment in the financial services industry;
- The successful completion of a core assessment to evidence competence, with additional assessments to achieve more senior/specialised accreditation;
- Ongoing professional development and continuing education requirements;
- A strong focus on ethical behaviour and conduct at both the adviser and the licensee level; and
- Efficient monitoring of the framework.

The Final Report agrees with such a framework, stating that the minimum standards required for advisers advising on anything but simple products[46] would be:

- A relevant tertiary degree;

[44] Parliamentary Joint Committee on Corporations and Financial Services 2009, *Inquiry into financial products and services in Australia,* Canberra, p87.

[45] These standards are set out in ASIC's Regulatory Guide RG 146, titled 'Licensing: training of financial product advisers.'

[46] Currently Tier-2, as set out in RG146.

- Competence in specialised areas, where relevant; and
- Ongoing professional development, including technical skills, relationship skills and ethical requirements.

7.4.2 Register of Financial Advisers

The other part of the recommendation from the Final Report is for the 'establishment of an enhanced public register of all financial advisers, which includes those that are employees…the register should include licence status, work history, education, qualifications and credentials, areas of advice, employer, business structure and years of experience.'[47] The goal of the register is to inform consumers of the distinguishing features between advisers and aid choice accordingly. This register will be an enhancement upon the existing list held by ASIC of AFSL holders and their authorised representatives.

AFMA participated on the industry working group advising the Government about the establishment of the register, which became operational on 31 March 2015.

7.4.3 Parliamentary Joint Committee Report

It is noted that, subsequent to the issuance of the Final Report, the PJCCFS issued its Final Report on the 'Inquiry into proposals to lift the professional, ethical and education standards in the financial services industry.' The recommendation of the PJCCFS are largely aligned to those set out in the Final Report, particularly in terms of the requirements to be adhered to by advisers to demonstrate competence.

The PJCCFS recommends that a 'Finance Professionals' Education Council' be established as an independent body established to set and monitor the educational framework that applies to financial advisers. In terms of the educational framework, the PJCCFS recommends that:

- The minimum educational standard for financial advisers should be degree qualification;
- For new entrants, advisers will be required to compete a structured professional year and pass a registration exam;
- There is to be mandatory ongoing professional development; and
- Any individual wishing to provide financial advice be required to be a member of an appropriate professional body and adhere to that body's code of conduct and ethics.

In addition, the PJCCFS agreed with the establishment of a register of financial advisers. The Government issued a Media Release in October 2014 setting out the Government's view as to what should be included on the register[48], and the PJCCFS agreed with these inclusions. They are largely

[47] Australian Government, *Financial System Inquiry Final Report*, November 2014, 222

[48] Senator The Hon. Mathias Cormann, Minister for Finance & Acting Assistant Treasurer, Media Release, *An Enhanced Public Register for Financial Advisers,* 24 October 2014.

the same as those recommended by the Final Report but also include memberships of professional associations, previous licensees/employers and any bans, disqualifications or enforceable undertakings.

The Government has now commenced a public consultation process about lifting the professional, ethical and education standards in the financial services industry, and the recommendations of the PJCCFS in this regard. AFMA will continue to be an active participant in this process.

7.5 Product Intervention Power for ASIC

The recommendations in the Final Report, as they relate to consumer outcomes, have focussed on improving the framework within which financial services participants deal with consumers. As noted above, the Final Report takes the approach of empowering consumers to make, and be responsible for, decisions by promoting a framework within which consumers are treated fairly and are able to obtain advice from advisers who are both competent and have aligned interests. The other salient recommendation by the Final Report seeks to enhance the robustness of this framework by increasing ASIC's powers to intervene to prevent conduct that is outside such a framework. The recommendation is that the Government:

> 'introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is a risk of significant consumer detriment.'[49]

Specifically, under this recommendation, ASIC would be able (in certain circumstances) to require or impose:

- Amendments to marketing and disclosure materials;
- Warnings to consumers, and labelling or terminology changes;
- Distribution restrictions; and/or
- Product banning.

7.5.1 The FSI View of the Current Regulatory Regime

The Final Report notes that, currently, ASIC may only take action where there has been a breach or a suspected breach of the law by a firm. This limits ASIC's power to pre-empt risks of significant consumer detriment, particularly across a class of consumers and take measures in advance to mitigate either the chance of the risk materialising or the losses that would accrue. This is particularly necessary, from the FSI Panel's perspective, given that changes in technology allows investors increasing access to complex products, which may be badged in a way that gives an alternative impression. Essentially, the recommendation of an intervention power is in response to a view of the FSI Panel that 'many cases of financial firm failure include situations where consumers

[49] Australian Government, *Financial System Inquiry Final Report*, November 2014, 206

have failed to understand the risk/return trade-off involved in a product, even if disclosure and advice were compliant.'[50]

The recommendation is consistent with that made by the Senate Economics Committee on the performance of ASIC, which recommended that 'urgent attention be given to providing ASIC with the necessary toolkit to prevent consumer detriment through allowing ASIC to intervene and prohibit the issue of certain products in retail markets.[51]'

It is noted that the recommendation from the FSI Panel is that any intervention power be used as a measure of last resort.

7.5.2 Stakeholder Views

Insofar as the recommendation would significantly expand the powers available to ASIC, stakeholders have expressed concerns as to the implications both for issuers and the market for financial products. AFMA, in its submission to the Interim Report, stated that it would be 'concerned about additional powers that enabled ASIC, for instance, to seek to ban a product or a class of products based on subjective criteria determined by the regulator.'[52] This was particularly the case given AFMA's view that the existing regulatory toolkit available to ASIC includes powers to stop products being offered or to require additional disclosure, and to require changes to advertising and marketing materials.

There are also substantive concerns about the potential for the power (or indeed the mere existence of the power) to stymie product innovation or whether ASIC has the necessary resources to exercise the power appropriately. There was also the suggestion (as set out in the AFMA August 2014 submission) that the existence of the intervention power may create moral hazard issues for ASIC in instances where it was not used and yet consumers suffered losses.

There are also concerns as to how financial firms will react to the existence of the power in terms of their engagement with ASIC. If an intervention power is introduced, it is likely an informal process will emerge whereby firms will engage with ASIC at the product development stage to try to ascertain the likelihood of ASIC invoking the power.

7.5.3 Design and Implementation of the Power

The Final Report seeks to ameliorate these concerns through the design and implementation of the product intervention power. In particular, the power is not to be used as a 'pre-approval' given the moral hazard associated with a regulator tacitly endorsing a product which bears some risk. The Final Report also states that the power is not to be used to 'alleviate consumers from bearing

---

[50] Australian Government, *Financial System Inquiry Final Report*, November 2014, 211

[51] Australian Government, *Financial System Inquiry Final Report*, November 2014, 209, citing Senate Economics References Committee, *Performance of the Australian Securities and Investment Commission,* Canberra, Commonwealth of Australia, 442-443.

[52] AFMA, *Submission to the Financial System Inquiry Interim Report,* 26 August 2014, 37.

responsibility for their financial decisions,'[53] although it is difficult to see how this would not be the perception from the consumer community. Additionally, it is expected that ASIC will engage with firms before formally using the power, such that reputational damage may be reduced. Finally, in terms of appropriately constraining the use of the power and ensuring accountability, the FSI Panel recommends that 'ASIC would be expected to engage with potentially affected firms and consult with the Council of Financial Regulators colleagues before any use of the power.' The mechanism for this to occur, which appears practically difficult, is unknown.

7.5.4 Prohibiting Distribution

While the proposed product intervention power is a considerable shift in the regulatory paradigm dealing with the consumer framework, the Final Report did not recommend a more draconian step undertaken in other jurisdictions: prohibiting the distribution of certain classes of product to retail consumers. Essentially, the FSI Panel does not believe that removing choice for a range of consumers who may understand the risks involved with such products is consistent with a desirous framework. AFMA agrees with this view, and notes that any proposal to prohibit distribution would necessitate large scale reform of the Corporations Act and the principles that underpin the Act.[54]

In the absence of the kind of large scale reform referred to above (or indeed, any recognition that this type of reform is justified or required), AFMA argues that it is not appropriate to create an intervention power for ASIC that would enable it to interfere with or prohibit distribution of certain types of products to some types of customers in an indirect way.

AFMA recommendation to Government

AFMA supports measures to improve investor confidence in and understanding of financial products. However, the potential restraining effects of an intervention power on innovation must also be taken into account. To the extent that an informal vetting process might develop as mentioned above, as issuers try to mitigate their risk that ASIC will seek to invoke the intervention power post-issue of a product, it may be preferable to formalise the pre-issue process, akin to the prospectus registration process that existed in the Corporations Act prior to the CLERP 6 reforms in the late 1990s.

For example, a requirement could be introduced that new products (ie. products of a type that are not currently available to retail investors), or products with particular characteristics that make them more complex than other products, are subject to a review process by ASIC prior to being issued. The nature of the types of financial products that would be subject to this type of process would need to be carefully defined – AFMA is proposing that only a small minority of products would be caught.

Similarly, to the extent there is concern that the current disclosure regime does not work effectively, new types of disclosure requirements could be mandated for products subject to the pre-issue

[53] Australian Government, *Financial System Inquiry Final Report*, November 2014, 211.

[54] AFMA, *Submission to the Financial System Inquiry Interim Report,* 26 August 2014, 38.

review process. It is not envisaged that "vanilla" products or products that are substantially similar to other products already on issue and available to retail investors would be subject to the review process.

It could be appropriate, in the context of an industry funding model, for ASIC to charge a fee for this review service.

The advantage of a pre-issue review process is that it would create a level of certainty for the product issuer but also for any investors who invest in the product – there are numerous legal, tax and other consequences yet to be thought through about what would happen to the value and status of an investment in a scenario where an investor acquires a product which is then at some later date subject to an intervention by ASIC.

There would be an opportunity to make changes to product terms and conditions (to the extent reasonable to ensure consumer protection) and to rectify disclosure deficiencies. In some extreme cases, a product may not come to market as a result of the review process.

Whether the Government decides to implement a pre-issue review process like the one described above, or a product intervention power of the type described in the Final Report, it is important to recognise that many of the issues and problems that have occurred in the retail investment sector have been as a result of poor advice and sales practices, as opposed to endemic issues related to product design (with some exceptions).

8. THE CORPORATE BOND MARKET

The further evolution of the corporate bond market is an issue that AFMA has long advocated and is keen to pursue. AFMA, together with other bodies such as the Group of 100, believe that 'a strong domestic market for corporate bonds to be an important funding platform which would have significant positive impacts for Australian corporates and the broader economy.'[55]

Similarly, it is apparent that the FSI Panel have spent considerable time pondering the status and potential of Australia's corporate bond market. Noting that 'a deeper and more liquid corporate bond market would provide diversification benefits to both issuers and investors,'[56] the observation was made that 'Australia has an established corporate bond market, although a range of regulatory and tax factors have limited its development.'[57] The response from the FSI Panel in the Interim Report was to focus on supply-side constraints, with potential policy options including allowing listed issuers to issue 'vanilla' bonds without a prospectus, and consideration of the thresholds within which a bond may be considered 'vanilla.' This resulted in a recommendation in the Final Report that the Government should:

> 'reduce disclosure requirements for large listed corporates issuing 'simple' bonds and encourage industry to develop standard terms for 'simple' bonds.'[58]

This recommendation represents a balancing exercise between the reduction of issuance costs while maintaining sufficient disclosure to allow retail investors to make appropriate investment decisions. To that end, the Final Report expresses caution as to the entities that should be able to take advantage of the reduced disclosure requirements, and recommends that only the top 150 companies by market capitalisation on the ASX should be eligible, given the amount of publicly available information with respect to these companies.

While the recommendation addresses the supply side issues, the Final Report is notably silent on the factors that have limited demand for corporate bonds, especially the 'tax factors' referred to in the Interim Report. Given that Appendix 2 to the Final Report refers to the 'relatively unfavourable tax treatment of…fixed-income securities (that) makes them less attractive as forms of saving,'[59] one can assume that the FSI Panel accept that the inability to allocate franking credits to returns on fixed income securities provides a disincentive for consumers to invest in such securities. This is an interesting proposition, insofar as the issuer is able to treat returns on fixed-income securities as deductible for tax purposes and, theoretically could price in the value of the deduction into the yield on the security. Accordingly it is not apparent why returns on fixed income securities are considered to be 'relatively unfavourable.'

---

55 Group of 100, Submission to the Financial System Inquiry, *Corporate Bond Market,* 16 September 2014

56 Australian Government, *Financial System Inquiry Interim Report*, July 2014, 2-86

57 Australian Government, *Financial System Inquiry Interim Report*, July 2014, 2-86

58 Australian Government, *Financial System Inquiry Final Report*, November 2014, 263

59 Australian Government, *Financial System Inquiry Final Report*, November 2014, 278

AFMA recommendation to Government

Should the Government be minded to adopt the Inquiry's recommendation, AFMA and its members will take a leadership role in the development of standard terms and conditions, and appropriate disclosure. It has been noted that there may be resistance to this proposal due to concerns about the quality of disclosure, and the level consumer understanding about investing in bonds. However, there is an opportunity to develop innovative documentation and new forms of disclosure that are not subject to the constraints of the current disclosure regime in the Corporations Act.

9. SIGNIFICANT MATTERS

Corporations Act 2001 ownership restrictions

Recommendation 44 of the Final Report is that market ownership restrictions should be removed from the Corporations Act 2001 once the current reforms to cross-border regulation of financial market infrastructure are complete.

AFMA supports an open competitive environment for market infrastructure where it is of benefit to market users. Regulators need appropriate tools necessary to manage systemic risk, and we note that the Council of Financial Regulators is consulting on a financial market infrastructure resolution regime with step-in arrangements. AFMA will continue to be an active participant in this process.

It has been noted that once these arrangements are in place, the issue of who owns the infrastructure will not be as relevant as it once was - particularly in an increasingly globalised world where foreign based facilities are able to operate in Australia in competition with domestic operators such as ASX (eg. there is competition in OTC derivatives clearing). If ASX were to be covered by the general ownership limits that apply to other significant financial institutions that would seem to be sufficient. AFMA understands that FIRB process will continue to apply in cases of cross-border mergers.

AFMA recommendation to Government

AFMA supports the proposal in the Final Report, subject to implementation of the other arrangements referred to above.

10. CONCLUSION

The Final Report represents a timely review of the financial system in the wake of the global financial crisis of 2008-09. However, the demonstrable resilience of the Australian financial system in the face of a major international credit market shock suggests that the basic architecture of the system is sound. This is in no small part due to the solid foundations laid by the Final Report's predecessors, the Campbell and Wallis inquiries.

The Final Report explores a wide range of themes and issues relevant to the future development of the financial system, but struggles to tie these together into a unified approach or framework that can then be championed at a political level. Instead, the Final Report largely constitutes a housekeeping exercised, geared to addressing the various issues of the moment. AFMA's submissions to the inquiry emphasised the need for a coherent approach to the future development of the financial system that would better position Australian financial institutions and markets to capitalise on the opportunities presented by the emerging regional trade in financial services.

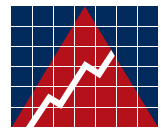
The report emphasises the need for a resilient financial system, however, its recommendations in relation to capital adequacy, mortgage risk-weights and loss absorbing capacity raise significant implementation issues that will need to be addressed in the Government's and regulators' responses. In particular, these recommendations will need to be adapted to reflect the still emerging approach being taken by regulators in a global context.

The recommendations in relation to superannuation and retirement incomes policy are mostly less controversial, but will require considerable buy-in on the part of policymakers and the investment of political capital to make them work. The over-arching issue with superannuation has been the failure of successive Governments to provide a stable policy and tax framework that would support confidence in the system. The Final Report highlights the extent to which the superannuation system remains a work in progress.

While only minimal changes are proposed to the regulatory architecture for the financial system, the proposed shift to an industry funding model for ASIC represents a significant change in the relationship between ASIC, the Government and the regulated community. In developing an industry funding model, careful attention will need to paid to ensuring effective oversight and accountability of ASIC's costs and its use of any new powers. The Final Report's recommendations contain some but not all of the elements of an appropriate accountability framework.

In the area of consumer outcomes, the report taps into a widely held view that standards in relation to financial advice and advisers need to be raised and proposes a number of measures to this effect which are already broadly supported by policymakers. More controversial is the proposed new product intervention power for ASIC which raises important issues around how ASIC might balance the use of this power against recognition that all financial products contain some element of risk and the need not to stifle innovation.

The report reflects a widespread view that Australia should further develop its corporate bond market, in particular, by improving access for retail investors. However, the report does not address explicitly the taxation issues that have inhibited the development of this market. This points to a broader weakness in the way the inquiry has sought to address taxation issues based on its interpretation of its terms of reference and their relationship to the Tax White Paper process.



Australian Financial Markets Association Ltd

ABN 69 793 968 987

Level 25, Angel Place, 123 Pitt Street Sydney NSW 2000

Telephone: + 61 2 9776 7955 Fascimile: + 61 2 9776 4488 Email: info@afma.com.au

www.afma.com.au