Business Council of Australia

Submission on the Final Report of the Financial System Inquiry

MARCH 2015

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The Business Council of Australia (BCA) is a forum for the chief executives of Australia's largest companies to promote economic and social progress in the national interest.

About this submission

This is the Business Council of Australia's submission on the final report of the Financial System Inquiry (FSI). The inquiry is an opportunity to implement policies that will improve the financial system's global competitiveness and enhance its ability to fund future growth in the Australian economy. The FSI Report's 44 recommendations are included in the attachment.

Key BCA recommendations

1. The government should use the findings and recommendations in the FSI report to design and implement a pro-competitive policy reform agenda that will improve the financial system's global competitiveness and enhance its ability to fund future growth in the Australian economy.
2. While we agree the system should be 'unquestionably strong', when considering the proposed changes to financial system regulation the government should avoid making changes that add costs to the economy and risk slowing economic growth, unless there is no other market or policy option available and the benefits to the economy are clearly demonstrated to outweigh the costs. Australia's regulations need to remain consistent with the international regulatory framework for banks.
3. The tax observations identified by the inquiry should be referred to the tax white paper process.

The FSI Final Report makes positive findings about the system

The FSI review panel has undertaken a comprehensive assessment of Australia's financial system and generally makes positive findings about its performance:

> "Australia's financial system has performed well since the Wallis Inquiry. Australia has a competitive financial system with sophisticated capital markets and firms that are quick to adopt new technologies that reduce costs or provide improved products and services."
> (p. 12).

The inquiry considers that Australia's regulatory architecture does not need major change, however 'minor refinements' may improve current arrangements:

> "... Australia's financial system is at risk of falling short of its potential to operate in a manner characterised by efficiency, resilience and fair treatment." (p. 12)

It lays out several key 'themes' for considering policy changes that could put the system on a stronger footing to deal with the challenges of the future. Chief among these are the themes of:

- funding the Australian economy
- the importance of competition.

Another prominent theme is ‘resilience’ where the report urges the need for a system that is ‘unquestionably strong’. Similarly, technology and digitisation are highlighted in the context of policy settings that promote innovation to drive economic growth and productivity.

The report sends an important message to the parliament that a strong budget position is critical for a stable, robust and efficient financial system and for sustainable economic growth. The report also notes that a reduction in Australia’s AAA sovereign credit rating would likely “lead to the banks’ credit ratings being downgraded, increasing funding costs.” (p. 44)

The government should implement a pro-competitive reform program

Why we need a reform agenda to support growth

The Business Council recommends that the government should draw upon the findings of the FSI to develop a reform program that will improve the long-term global competitiveness of the financial sector.

The FSI report provides the opportunity to further develop Australia’s financial services sector as a contributor to economic growth and a growing source of export income. This opportunity has been recognised by the NSW Government, which established a financial services knowledge hub in March 2015 to drive innovation. Additionally, the Business Council report, *Building Australia’s Comparative Advantages*, identified the financial services sector as an industry with strong potential to grow.

A pro-competitive reform program should ensure that Australia’s financial services sector is well placed to seize the growth opportunities that are available to it and can efficiently and sustainably fund growth in the Australian economy.

Australia’s economy is set for considerable expansion with a growing population and strong trading relationships with the fast-growing Asia–Pacific economies. According to the latest Intergenerational Report (IGR), Australia’s population will reach almost 40 million by 2054–55 with our economy growing on average at 2.8 per cent a year.

The financial sector will play an essential role in funding the new investments that will be needed to expand productive capacity, lift incomes and create jobs.[1]

There is a need for pro-competitive reforms to enable the financial sector to respond to the increased digitisation of the economy and rapid pace of technological change, and to promote innovation. To be globally competitive, the financial system will need to be flexible in its response to changes in technology, new and growing business and consumer requirements, and shifts in global capital markets, while also maintaining high integrity standards.

1. The final report does not provide a detailed analysis of Australia's future economic growth prospects and the implications for funding. For instance, in discussing population the report refers to the ageing of Australia's population, but does not acknowledge that our population is also growing and that this will increase demand for funding and financial services.

The governance and accountability framework for Australia's financial regulators needs to recognise these challenges and remove undue regulatory costs on business. The new Regulator Performance Framework should lead to improved regulatory administration.

Components of a pro-competitive reform agenda

Many of the recommendations in the FSI report are suitable for a pro-competitive reform agenda but are directional in nature and require further development.

The Business Council nominates these FSI report recommendations as priority areas for a pro-competitive reform agenda for the sector:

- superannuation system reforms (recommendations 9–13)
- innovation (recommendations 14, 15, 18–20)
- consumer outcomes (recommendations 23 and 25)
- the regulatory system (recommendations 27, 31 and 33)
- significant matters (recommendations 38, 39, 43 and 44).

(See the attached table for a description of each recommendation.)

Each of the reforms should be referred to the appropriate government agency or statutory authority, so they can be further developed and properly tested for their economic impact. There should be consultation with industry around the implementation of any changes.

Resilience

In finding that the system performs well, the report also identifies a need to make the system 'unquestionably strong' and more resilient to potential future economic shocks. To that end it recommends raising the capitalisation and risk weights of major banks, but acknowledges that these recommendations warrant 'more in-depth discussion' (Recommendations 1 and 2).

In evaluating these recommendations, the benefits need to be as well defined as possible, and all alternative options fully assessed. For the reasons outlined earlier, regulation that adds costs to Australia's growing economy should be avoided unless there is a clear problem to be addressed, there is no other market or policy option available, and the benefits of regulation outweigh the costs.

Regulation should maintain an efficient risk-based approach to capitalisation in order to promote economic efficiency and ensure the system is operating in the long-term interest of consumers.

The report acknowledges that the recommendation to lift capital ratios will impose costs on the economy for benefits that are less able to be clearly measured.[2] To the extent Australian banks need more capital, it should be aligned with international regulation and

2. The report claims the costs would be justified if an additional percentage point of capital were "to reduce the probability or severity of a crisis by 1 in 25 to 1 in 30" .

the timing should reflect current economic needs, recognising that lifting capital requirements can impact on economic growth.

The recommendation to raise risk weights has a secondary objective of addressing issues for competition arising from the different risk-weighting systems that apply to banks. While there may be benefits from narrowing the gap, it is noted the suggested approach will impose costs on the economy, and alternative options to improve standard risk-weighting systems or pursue faster IRB accreditation for non-IRB banks should continue to be considered.

Taxation

The tax issues observed by the inquiry, including distortions in the tax treatment of savings vehicles and the economic costs of withholding taxes, should be referred for further consideration to the upcoming Commonwealth white paper on taxation. In time, policy reforms in these areas should be considered as components of a pro-competitive reform agenda for the financial sector.

Consistency with other reviews

The government's response to the FSI Final Report will need to be consistent with its response to the competition policy review, its fiscal strategy and the upcoming review into the tax system. All major economic policies must work together to serve an overarching and coherent strategy to grow the economy and lift the living standards of Australians.

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Attachment

Financial system inquiry final report recommendations

Shaded recommendations are those that the inquiry considers warrant 'more in-depth discussion'

No.	Recommendation
Resilience	
1	**Capital levels** Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.
2	**Narrow mortgage risk weight differences** Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.
3	**Loss absorbing and recapitalisation capacity** Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.
4	**Transparent reporting** Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework.
5	**Crisis management toolkit** Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the inquiry.
6	**Financial Claims Scheme** Maintain the ex post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.
7	**Leverage ratio** Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions' risk-weighted capital positions.
8	**Direct borrowing by superannuation funds** Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.
Superannuation and retirement incomes	
9	**Objectives of the superannuation system** Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.

No.	Recommendation
10	**Improving efficiency during accumulation** Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.
11	**The retirement phase of superannuation** Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.
12	**Choice of fund** Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.
13	**Governance of superannuation funds** Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.
Innovation	
14	**Collaboration to enable innovation** Establish a permanent public–private sector collaborative committee, the 'Innovation Collaboration', to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.
15	**Digital identity** Develop a national strategy for a federated-style model of trusted digital identities.
16	**Clearer graduated payments regulation** Enhance graduation of retail payments regulation by clarifying thresholds for regulation by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority. Strengthen consumer protection by mandating the ePayments Code. Introduce a separate prudential regime with two tiers for purchased payment facilities.
17	**Interchange fees and customer surcharging** Improve interchange fee regulation by clarifying thresholds of when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees. Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.
18	**Crowd funding** Graduate fundraising regulation to facilitate crowd funding for both debt and equity and, over time, other forms of financing.

No.	Recommendation
19	**Data access and use** Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.
20	**Comprehensive credit reporting** Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime. If, over time, participation is inadequate, government should consider legislating mandatory participation.
Consumer outcomes	
21	**Strengthen product issuer and distributor accountability** Introduce a targeted and principles-based product design and distribution obligation.
22	**Introduce product intervention power** Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.
23	**Facilitate innovative disclosure** Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.
24	**Align the interests of financial firms and consumers** 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.
25	**Raise the competency of advisers** Raise the competency of financial advice providers and introduce an enhanced register of advisers.
26	**Improve guidance and disclosure in general insurance** Improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance.
Regulatory system	
27	**Regulator accountability** Create a new Financial Regulator Assessment Board to advise government annually on how financial regulators have implemented their mandates. Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.
28	**Execution of mandate** Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews.
29	**Strengthening the Australian Securities and Investments Commission’s funding and powers** Introduce an industry funding model for the Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.

<table>
<tr><th>No.</th><th>Recommendation</th></tr>
<tr><td>30</td><td>Strengthening the focus on competition in the financial system
Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission’s mandate.</td></tr>
<tr><td>31</td><td>Compliance costs and policy processes
Increase the time available for industry to implement complex regulatory change.
Conduct post-implementation reviews of major regulatory changes more frequently.</td></tr>
<tr><td colspan="2">Significant matters</td></tr>
<tr><td>32</td><td>Impact investment
Explore ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery.
Provide guidance to superannuation trustees on the appropriateness of impact investment.
Support law reform to classify a private ancillary fund as a ‘sophisticated’ or ‘professional’ investor, where the founder of the fund meets those definitions.</td></tr>
<tr><td>33</td><td>Retail corporate bond market
Reduce disclosure requirements for large listed corporates issuing ‘simple’ bonds and encourage industry to develop standard terms for ‘simple’ bonds.</td></tr>
<tr><td>34</td><td>Unfair contract term provisions
Support government’s process to extend unfair contract term protections to small businesses.
Encourage industry to develop standards on the use of non-monetary default covenants.</td></tr>
<tr><td>35</td><td>Finance companies
Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from those of authorised deposit-taking institutions.</td></tr>
<tr><td>36</td><td>Corporate administration and bankruptcy
Consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.</td></tr>
<tr><td>37</td><td>Superannuation member engagement
Publish retirement income projections from defined contribution superannuation schemes on member statements using Australian Securities and Investments Commission (ASIC) regulatory guidance.
Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC’s and superannuation funds’ retirement income projection calculators.</td></tr>
<tr><td>38</td><td>Cyber security
Update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation, and progress public–private sector and cross-industry collaboration.
Establish a formal framework for cyber security information sharing and response to cyber threats.</td></tr>
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No.	Recommendation
39	**Technology neutrality** In consultation with the financial sector, identify and amend priority areas of regulation to make them technology neutral. Embed consideration of the principle of technology neutrality into development processes for future regulation. Ensure regulation allows individuals to select alternative methods to access services to maintain fair treatment for all consumer segments.
40	**Provision of financial advice and mortgage broking** Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.
41	**Unclaimed monies** Define bank accounts and life insurance policies as unclaimed monies only if they are inactive for seven years.
42	**Managed investment scheme regulation** Support government's review of the Corporations and Markets Advisory Committee's recommendations on managed investment schemes, giving priority to matters relating to: • consumer detriment, including illiquid schemes and freezing of funds regulatory architecture impeding cross-border transactions and mutual recognition arrangements.
43	**Legacy products** Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.
44	**Corporations Act 2001 ownership restrictions** Remove market ownership restrictions from the Corporations Act 2001 once the current reforms to cross-border regulation of financial market infrastructure are complete.