KPMG
cutting through complexity

Senior Adviser
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

31 March 2015

Financial Systems Inquiry: KPMG's submission to Treasury, Treasurer and Treasury Ministers

Thank you for the opportunity to respond to the 44 recommendations set out in the Financial Systems Inquiry (FSI) Report released on the 7th December 2014.

As a leading professional services firm, KPMG is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also investors, employees, governments, regulators and the wider community.

We strive to contribute to the debate that is shaping the financial services industry. During the FSI Inquiry KPMG submitted two documents outlining our key observations and recommendations, these included the following themes:

- Improving our regulatory framework to better balance stability, growth and efficiency
- Enhancing diversification of funding and supporting superannuation investment in long term asset classes
- Re-purposing the superannuation industry to better address longevity risk
- Encouraging innovation in the industry and responding to emerging technology risks

It was pleasing to read the final report addressed many of these topics in its recommendations.

We outline in this document KPMG's views on some of the key recommendations and would be pleased to provide further information that would assist the Treasurer as you are making decisions on recommendations and implementation.

Should you require any further information or have any question please contact Rachel Merton, Head of Government Relations on 02 9455 9109 or at rmerton@kpmg.com.au

Yours sincerely

Adrian Fisk
Partner, Head of Financial Services

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

FSI Final Report

Chapter 1: Resilience

The FSI Report contains a number of recommendations on the theme relating to financial system resilience. The report notes that the FSI's recommendations to improve financial system resilience aim to:

- "Strengthen policy settings that lower the probability of failure, including setting Australian bank capital ratios such that they are unquestionably strong by being in the top quartile of internationally active banks."
- "Reduce the costs of failure, including by ensuring authorised deposit-taking institutions maintain sufficient loss absorbing and recapitalisation capacity to allow effective resolution with limited risk to taxpayer funds — in line with international practice."

KPMG agrees with these objectives. A fundamental objective of financial sector regulation, particularly in relation to the banking system, but also more broadly, should be to promote a resilient financial system – i.e. a financial system that is capable of withstanding relatively severe economic and financial shocks. An essential element in meeting this objective is to ensure that financial institutions have the balance sheet strength, governance and risk management capacity to survive a plausible range of shocks. It is also essential that, if a financial institution does fail, the failure does not trigger contagion to other financial institutions or elsewhere in the financial system, and that the failure can be resolved cost-effectively with minimal disruption to systemically important financial services.

While KPMG strongly supports these aims, and considers financial system regulation should be calibrated to achieve a high level of financial system resilience, it also recognises the need to strike a sensible balance between promoting the resilience of the financial system and promoting the efficiency of the financial system. Taken to the extreme, regulation could be designed to attain a strong level of financial system resilience by setting capital and other regulatory requirements sufficiently high as to achieve a near-zero probability of institutional failure. While this would meet the objective of resilience, it would also potentially undermine the objective of financial system efficiency by severely inhibiting financial institutions' incentives and capacity to be innovative and to respond flexibly to changing customer needs, and by imposing excessive compliance costs and impediments to resource mobility in the financial system. Striking the right balance between financial system stability and resilience, on the one hand, and financial system efficiency, on the other, is therefore crucial.

In the context of this general observation, KPMG has some views on a number of the FSI's recommendations in relation to the financial system resilience theme, as set out below.

Recommendation 1 – Capital levels. Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.

KPMG endorses the recommendation that Authorised Deposit-taking Institutions (ADIs) capital ratio requirements be set at a level consistent with promoting a resilient banking system, based on realistic stress testing and taking into account international benchmarks, especially the capital standards promulgated by the Basel Committee on Banking Supervision (BCBS). Capital ratios need to be sufficiently high as to enable ADIs, especially those ADIs considered to be systemically important, to survive relatively severe economic and financial shocks. The FSI therefore rightly attaches importance to this issue. However, as noted above, it is important to recognize the potential trade-offs between resilience and efficiency outcomes. All else being equal, increased capital ratio requirements could be expected to strengthen banks' resilience, but they could also be expected to increase intermediation costs and reduce the scope for bank lending. There is also a risk that higher capital ratios, in the absence of close supervisory surveillance and appropriate governance, risk management and transparency requirements, could induce higher risk-taking by banks, thereby detracting from the resilience objective. Getting the right balance is therefore important.

A further consideration in relation to the setting of capital ratios – and one to which the FSI Report does not give adequate attention – is that the capital ratio is just one element in promoting a bank's resilience, and not necessarily the most important one. The Report compares banks' capital ratios in Australia with those in other comparable countries. It concludes that there is scope to raise capital ratio requirements in Australia to

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

ensure that the ratios are in the top quartile of the capital ratios for internationally active banks. Although that might be a reasonable aspiration in some respects, it does not adequately put the capital ratio argument into the context of broader risk settings for banks. It compares banks' capital ratios in Australia with those in various other countries without adequately taking into account such factors as:

- the supervisory requirements applied in Australia to banks' governance and risk management compared to the applicable requirements in other countries;
- the quality of governance and risk management frameworks of Australian banks compared to those of banks in other countries;
- the results of comprehensive stress testing in terms of banks' vulnerability to a range of economic and financial shocks;
- the extent of exposure concentration in Australian banks compared to those in other countries; and
- the extent and nature of inter-bank contagion risks in Australia compared to those in other countries.

Capital ratio requirements, and capital ratios, should be considered taking into account the above factors, among others, in order to meaningfully assess whether banks' capital ratios in Australia are satisfactory relative to international benchmarks. This recognises that a bank's capital ratio is merely one element in its resilience. Other factors that are also important in assessing a bank's resilience are the quality of its governance and risk management arrangements. Exposure concentration and inter-bank contagion are also important considerations, as are numerous other factors, such as the resilience of payment and settlement systems. Reflecting these factors, it might well be the case that a bank with a high capital ratio, but with relatively poor governance and risk management arrangements, and in a financial system with significant contagion channels, is much less resilient than a bank with a considerably lower capital ratio but with good quality governance and risk management and in a low contagion environment. Accordingly, without taking into account all these factors, the comparison of capital ratios between banks in different jurisdictions is inadequate.

Moreover, as noted in the FSI Report, the capital ratio measurement frameworks differ considerably from country to country, even though they are generally based on Basel III (or Basel II in some cases). Without adjusting for these differences – for example in the calibration of risk weights for specific categories of risk or the application of Pillar 2 adjustments to the capital ratio – comparisons of banks' capital ratios cannot be made accurately.

The Report also includes discussion of the issue of implicit government guarantees for banks (especially large banks), and presents this as a further factor justifying higher capital ratios. The presence of an implicit government guarantee of banks is undoubtedly significant in Australia. Few would argue that banks in Australia, especially the large banks, do not derive benefit from a presumption (rightly or wrongly) that the government would bail-out a medium to large bank in distress. Higher capital ratios might be part of the answer, but other options also exist and these need to be considered before any conclusions are reached.

For example, consideration could be given to substantially reducing the implicit government guarantee by introducing a bail-in tool – something that is currently missing from APRA's resolution toolkit, as the FSI Report notes. Bail-in, if applied sensibly and signalled as a likely resolution option, would go a long way towards reducing the presumption of government bail-out without necessarily requiring higher capital ratios. Other options can also be considered, but were not addressed in the FSI Report. One of these options is for the government to charge banks a risk-based fee for the implicit guarantee from which they benefit. Further consideration of all these matters would be beneficial.

KPMG therefore urges caution in the acceptance of the recommendation on capital ratios. We would suggest that the setting of capital ratio requirements, and the aspirational target zone for capital ratios in Australia compared to internationally active banks, should attach significant weight to the factors referred to above. Any comparisons of capital ratios of banks in Australia to banks in other countries needs to take into account these factors, as well as the significant differences in capital measurement frameworks across countries.

On this basis, before taking any action in relation to this recommendation, we think it would be desirable for APRA, in close consultation with the banking industry and other stakeholders, to undertake a comprehensive and transparent comparison of bank capital ratios in Australia with those in selected other advanced countries that takes into account all of the factors noted above. The analysis also needs to include a comprehensive assessment of the costs and benefits associated with higher capital ratios, with comparisons to the costs

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

and benefits of alternative options for achieving resilience. Once complete a meaningful assessment can be made of the adequacy of banks' capital ratios in Australia and a target zone for capital ratios be set.

Recommendation 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.

KPMG shares the view held by many ADIs that the current standardised capital risk weight in relation to residential mortgage lending does not adequately reflect the risk profile of residential lending, given its broad-brush risk weight calibration. This puts ADIs using the standardised capital framework (i.e. most banks and other ADIs) at a competitive disadvantage relative to banks using an APRA-approved Internal Ratings Based (IRB) model. It means that banks using the standardised approach generally need to hold more capital against every dollar of residential lending than do banks using the IRB approach. All else being equal, this reduces their competitiveness in residential loan pricing.

Some difference in risk weight between the standardised approach and IRB models approach is obviously warranted to the extent that the IRB approach more accurately measures the actual residential lending risks being taken by banks using those models. The question that needs to be considered is whether the difference in risk weight between the IRB and standardised approaches is over-stated, creating an unwarranted competitive advantage for banks using the IRB approach.

KPMG believes this issue requires further analysis before any conclusion is reached. The FSI Report does not contain sufficient analysis, in our view, to justify raising the IRB risk weight on residential lending. We therefore suggest that APRA, in close consultation with the banking industry and other stakeholders, undertake a comprehensive analysis of this issue before any changes are made to the capital risk weight arrangements. In addition, however, it is important that the analysis is not confined to the FSI proposal of raising the minimum IRB risk weight. The analysis should include consideration of introducing a more risk-based granularity to the standardised risk weights for residential lending as an alternative to increasing risk weights under the IRB approach. We suggest both options be considered.

In consideration of this issue, it is important to take into account the recent paper from the BCBS – *Revisions to the standardised approach for credit risk*. This paper is out for consultation until 27 March this year and sets out options for major changes to the risk weights in the capital framework. These include a more granular risk-based approach to the setting of risk weights for residential lending and to risk weights in many other categories of credit exposure under the standardised capital approach. Any changes to the capital framework in Australia should be made having close regard to the BCBS proposals once finalised, with a view to maintaining an appropriate degree of consistency with international standards.

As a matter of principle, KPMG supports the implementation of the Basel Framework by national regulators in a manner that involves limited additional application of national discretions. This has been APRA's approach to the standardised risk weights applied to residential mortgage lending. However, it has not been APRA's approach to the calculation of credit risk under the advanced or internal ratings based (IRB) approach to the calculation of credit risk weighted assets. In particular, APRA has imposed 'nexus' requirements for the development and accreditation of advanced capabilities for the calculation of credit risk, operational risk and IRRBB (refer APS 113, paragraphs 26 and 27). APRA also appears to have accepted only limited use of possible transitional arrangements in the implementation of the IRB approach to credit risk measurement across the asset classes, separately identified in the IRB approach, and which are significant to an ADI's own particular balance sheet. APRA's requirements for advanced accreditation can accordingly be viewed as being subject to a high degree of national discretion.

KPMG considers that it should be permissible for banks to seek IRB credit risk accreditation for certain asset classes on a transitional basis and to do so without also being subject to additional nexus requirements. It should be permissible for ADIs to implement such an approach starting with their residential mortgage portfolios.

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

Recommendation 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.

KPMG agrees with the need to ensure that banks, especially those considered to be systemically important, have sufficient loss absorption capacity to facilitate resolution in ways that minimises the risk of financial system instability and the need for taxpayer assistance via bail-out. Basel III goes some way towards this objective by requiring all qualifying capital instruments to be loss absorbing at the point of non-viability. APRA has implemented this element of Basel III.

Where further consideration is needed is on the issue of whether systemically important banks should be required to hold either a higher level of Basel III qualifying capital than is currently the case or to otherwise hold tranches of debt capable of loss absorption by contractual bail-in in a manner consistent with Financial Stability Board's (FSB's) Total Loss-Absorbing Capacity (TLAC) proposals released in November 2014[1]. The FSB proposals provide the logical starting point for this analysis, given that they represent the current international position of the FSB on TLAC issues and, if implemented, will form the basis of an international standard in this area for globally systemically important banks (G-SIBs). Although none of the Australian banks are G-SIBs, there are several banks in Australia that are classified as domestically systemically important banks (D-SIBs) and further banks that, in some circumstances, would also be systemically important at a domestic level. The same principles of loss-absorption capacity appropriately apply to D-SIBs as to G-SIBs, and hence the FSB proposals are relevant to the Australian situation.

In considering the extent and nature of loss-absorbing capacity required of systemically important banks in Australia, it will be important for the authorities to have close regard to a number of factors. These will include:

- the probability of default of each of the banks in question, having regard to stress testing and other forms of analysis;
- the market appetite for loss-absorbing debt instruments beyond the level required for Basel III purposes;
- the triggers for loss-absorption;
- the indicative terms required for loss-absorption eligibility; and
- the costs to banks, and therefore to bank customers, and the economy of imposing higher levels of loss-absorbing capacity.

In considering the options, it will also be important to assess the alternatives to requiring higher loss-absorbing capacity for banks, and the costs and benefits of these respective options. One important option in that regard is the capacity for statutory bail-in (assuming that new bail-in powers will eventually be enacted in Australia) as an alternative (or, more likely, a supplement) to contractual bail-in. On this basis, bail-in could be applied by the resolution authority (APRA) to any unsecured debt instrument upon defined triggers of non-viability being met, such that the debt in question is either converted to an eligible capital instrument or written down. Bail-in would follow the ranking of claims in a winding up and compensation would be payable to the extent it was warranted under 'no creditor worse off' principle recognised in the FSB *Key Attributes of Effective Resolution Regimes* (Key Attributes) – the international standard on resolution. The greater reliance that can be placed on bailing-in any category of unsecured debt in a resolution, the lower is the need for potentially costly tranches of contractually bail-in-able loss-absorbing debt.

We therefore urge that these issues be the subject of thorough assessment by APRA, in close consultation with the banking industry and other stakeholders, including an assessment of all practicable options and the costs and benefits of each. We also suggest that any initiatives taken in this area within Australia should be informed by the work of the FSB, International Monetary Fund (IMF) and BCBS, and by developments in comparable countries.

---

[1] *Adequacy of loss-absorbing capacity of globally systemically important banks in resolution* – Financial Stability Board – November 2014.

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

Recommendation 5 – Crisis management toolkit. ***Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry.***

KPMG endorses this recommendation. It is widely recognised that Australia does not have all of the statutory framework in place to facilitate the cost-effective resolution of ADIs and other financial institutions (including insurers and Financial Management Information Systems (FMIS)). This point was observed in the consultation paper issued by Treasury in 2012[2] and also noted in the IMF Financial Sector Assessment Program (FSAP) FSSA report in November 2012. In particular, the *Banking Act 1959* lacks a number of resolution powers that are recommended by the FSB in the Key Attributes, including in relation to group resolution, bridge bank, bail-in, temporary stays (qualified along the lines recommended by the FSB), branch resolution powers and a framework to enforce the 'no creditor worse off' principle. The inadequacy in statutory powers diminishes the ability of APRA to respond effectively to a financial crisis and increases the risk to taxpayers and the economy. It is essential that the Government address this matter by setting out comprehensive proposals for legislative reforms to strengthen the resolution framework for ADI, general insurers, life insurers, superannuation Registrable Superannuation Entities (RSEs) and FMIs. In that regard, we endorse the FSI recommendation, including that the issues be subject to a thorough process of consultation on the basis of clearly identified costs and benefits.

KPMG also notes that Australia has fallen behind many comparable countries in its preparedness for crisis resolution. Although APRA has implemented recovery planning for some ADIs, the same framework has not been introduced for insurers. Similarly, no recovery planning requirements have been introduced for FMIs by the RBA or ASIC. Moreover, APRA has not (to our knowledge) implemented resolution planning for ADIs. We suggest the regulators should focus on these areas to ensure that Australia is well equipped to manage a financial crisis if one is to occur, and to ensure that we are broadly in line with international best practice. However, as always, we would stress the need for the regulators to be open and thorough in their consultation with stakeholders in these areas.

Recommendation 7 – Leverage ratio. Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions' risk-weighted capital positions.

KPMG supports this recommendation. As is recognised internationally, a leverage ratio provides an effective backstop against the inherent vagaries of risk-weighted capital ratios. Although the risk-weighted capital ratio requirements are clearly fundamental to prudential soundness in the banking system, the leverage ratio provides a safety valve in terms of a simple floor below which no ADI is permitted to fall. It also serves as an addition trigger for recovery actions by an ADI, prompt corrective action by APRA and, if necessary, resolution. Introducing a leverage ratio would also bring Australia into line with prevailing international practice and BCBS requirements.

We therefore suggest that this issue be the subject of thorough consultation by APRA with the ADI industry and other stakeholders, with a view to assessing the costs/benefits of different leverage ratio settings and eventually establishing an appropriately calibrated leverage ratio requirement for all ADIs.

Chapter 2: Superannuation and retirement incomes

Recommendation 9 – Objectives of 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.

A key characteristic of a well-functioning organisation or system are clearly defined and understood objectives. Given the size and importance of Australia's superannuation system it is imperative that the objective(s) of the system are developed and enshrined in legislation.

The recommendation indicates that the core objective of Australia's superannuation system is to provide income in retirement to substitute or supplement the Age Pension. This recommendation has been widely

[2] *Strengthening APRA's crisis management powers.*

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

praised by all sectors of the superannuation industry, and will hopefully continue to add momentum for the development of additional retirement products and services.

Enshrining the objective within legislation also provides a mechanism for evaluating the performance of the system, proposed policy reforms and will improve confidence and stability in our globally recognised superannuation system.

Recommendation 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.

We agree with the premise that, in general, the transition from accumulation to retirement is inefficient and, therefore, we welcome the focus on retirement outcomes.

In our view there are two key elements required to maximise the likelihood of this recommendation achieving the objective of improving retirement outcomes.

- The first is the degree of specificity around the trustee's selection of a Comprehensive Income Product for Retirement (CIPR). We support the notion of a principles based approach around the general themes of longevity pooling and provision of regular income. We suggest an additional principle that the trustee must take into account the characteristics of its membership base in designing the CIPR.
- The second is the need for the trustee to have a strategy for how the CIPR will be communicated to the membership. The importance of having the trustee focus on the strategy stems from the fact that the report does not seem to envisage the CIPR forming part of a default mechanism or even an opt out. It is important that trustee is required to demonstrate both how it has designed a CIPR and it strategy for engaging with members.

Chapter 3: Innovation

Recommendation 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.

KPMG strongly supports this recommendation. We point to our recent report commissioned by the Committee for Sydney and NSW Government on financial technology (known as fintech), titled: *Unlocking the potential: the Fintech opportunity for Sydney*, which made a series of recommendations to the Government and the private sector in order to foster greater levels of collaboration and innovation in the financial services industry.

KPMG examined both established and emerging fintech hubs around the world – including Silicon Valley, New York, London, Tel Aviv, Dublin, Berlin, Singapore and Hong Kong - in order to identify a set of common characteristics for success:

Available and accessible early stage funding for fintech start-ups and a strong pipeline of opportunities for investors;

Deep financial services and technology talent and close proximity of these talent pools to each other within a city location;

A robust financial services industry, with a vibrant technology start-up community;

Government commitment and regulatory support; and

Business backing for a fintech hub, with high levels of collaboration and a culture which encourages innovation and risk taking.

The growth of Fintech is driving new and more collaborative models of innovation in financial services, bringing together financial institutions, government, technology start-ups and investors in new ways to provide better consumer (and investor) outcomes and access to finance for business.

As a result, KPMG made six recommendations for the public and private sector to help Sydney (and Australia) to become a leading fintech hub in the Asia Pacific region:

1. Develop a comprehensive fintech vision and strategy for Sydney (and Australia);

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

2 Establish a not-for-profit fintech hub in the heart of the city;
3 Promote Sydney (and Australia) as the leading fintech centre in the ASPAC region;
4 Form an independent fintech focussed industry association
5 Enhance the current regulatory, tax and business incentives available to the start-up community; and
6 Engage the university sector and leverage research institutes, to research key fintech themes and explore business opportunities.

Since the report's public release last October a group of senior stakeholders across NSW Government, the Committee for Sydney, the financial services, technology and professional services industries, academia and the fintech entrepreneurial community have been working together to develop a physical fintech hub in Sydney, called *Stone and Chalk*. Please refer to the media release on this recent announcement, as well as Stone and Chalk's website for further information.

The *Stone and Chalk* fintech hub is consistent with the recommendations in the FSI Final Report, calling for a permanent public-private sector collaboration committee to be established, comprising industry, government, regulatory, academia and consumers to facilitate financial system innovation and a more flexible regulatory framework.

Therefore, KPMG proposes that *Stone and Chalk* would be the ideal location to host Innovation Collaboration (IC) forums and initiatives, similar to what occurs in the UK market with Level39. *Stone and Chalk* is being purpose built to facilitate collaboration between fintech start-ups and established financial services institutions, Government and regulatory authorities and will provide an effective mechanism for engagement to move readily occur and for the views of fintech innovators to be heard by policymakers.

Stone and Chalk's Board, executive and members (of which KPMG is one) would welcome the opportunity to further explore this possibility with Government in the coming months.

Recommendation 15 – Digital identity. Develop a national strategy for a federated-style model of trusted digital identities.

Recommendation 15 of the FSI Report suggests that we need to strengthen Australia's digital identity framework through the development of a national strategy for a federated-style model of trusted digital identities that enhances consumer choice, privacy and security, and balances these objectives with financial system efficiency.

The key overriding benefit is the protection for both consumers and businesses. Consumer fraud currently costs Australians in the region of $89 million per year, according to the most recent data from the Australian Competition and Consumer Commission[3]. And the cost to business is epic. According to The Australian Institute of Criminology, fraud costs some $8.5 billion annually.[4]

With many individuals and businesses affected by losses related to identity breaches, there's a clear need to address the issue. But productivity and innovation are also driving the initiative, with the desire of businesses, government and consumers to move to online and mobile channels demanding a better digital identity regime.

A stronger digital identity framework is imperative if Australia wants to fully embrace digital consumerism. Together with the Government's Cyber Security Review and the new Australian Privacy Principles, it will provide a more robust economic environment both within Australia and internationally.

Overcoming the challenge of centralisation

Creating a centralised framework has always been a key challenge in Australia. Many will remember the failure of the Australia Card, a national identification scheme. Legislation to support the card failed to pass in the Senate three times in the mid-1980s – a reflection of fear of having just one central source of identity that falls under government control.

---

[3] Australian Competition and Consumer Commission, Targeting Scams report 2013.

[4] http://www.aic.gov.au/crime_community/communitycrime/costs.html

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

In January 2015, the government announced myGov would be expanded across federal, state and local governments. While the expanded myGov platform will drive productivity benefits for government and the consumer's interacting with them, this platform will not drive similar benefits for businesses. Furthermore, similar to the Australia Card approach, the centralised nature of the myGov model may see businesses and consumers reticent to engage if it is expanded at a later date.

While MyGov adopts a centralised approach, the federated model being pursued under the FSI recommendations should take the heat out of this particular concern. By enabling a number of trusted and approved suppliers to hold digital identities that are chosen by individuals, consumers will retain a sense of control. Under this model, individuals can set up a range of identities with different providers depending on how much or how little they may want to disclose.

The close involvement of business will also help – the scheme will not be seen as a government initiative, but collaboration between business, government and consumers.

The involvement of business is also imperative to keep the initiative moving at a fast pace. A government-only scheme would lack the capability that the private sector can contribute.

Understanding the costs

While there will be some costs involved for business, we don't believe they will be onerous given this framework will facilitate existing Know Your Customer (KYC) requirements under the Anti-Money Laundering (AML) legislation. Costs will also be offset by increased efficiency – verifying identity is very expensive and repetitive. For example, myGov, the online gateway to multiple government services using a single set of digital credentials, is forecast to generate around $547 million in efficiency savings and reduced red tape burden over 10 years.

It is critical that privacy and security are incorporated into the design, development and operation of the federated digital identity framework – the framework could be compromised if consumers fear that their security will be breached because of poor design or implementation.

Italy and the UK: pioneering digital identity frameworks

Fortunately, we will be able to observe as others move forward with new digital identity models. At the end of 2014 Italy announced regulations to implement the Italian Digital Identity Initiative, called "Sistema Pubblico di Identità Digitale" (SPID). SPID defines a Federated Identity Management system involving individuals, service providers, identity providers, attribute providers and the Digital Agency for Italy, in the role of accreditation and registry authority. At the start of last year, the UK government also rolled out an identity assurance framework to give people a secure and convenient way to sign in to government services.

Both initiatives will provide templates for Australia as we move down the digital identity path.

Recommendation 18 – Crowdfunding. Graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.

KPMG supports facilitating crowd funding and other innovative sources of finance. We support the recommendation to facilitating crowd funding by adjusting fund raising and lending regulation, streamlining issuer's disclosure requirements and allowing retail investors to participate in this new market, with appropriate protections such as caps on investment. Small to medium enterprises (SMEs) are an important part of the Australian economy for job creation and growth. These initiatives increase opportunities for SMEs to seek finance from the general public.

Recommendation 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.

KPMG supports this recommendation. As KPMG has argued in a report provided to the Australian Retail Credit Association (ARCA), in support of ARCA's proposals for an industry-based credit reporting framework – the *Principles of Reciprocity and Data Exchange* (PRDE) – there are major benefits associated with an industry-agreed framework for exchanging comprehensive credit data.

The exchange of comprehensive credit data between credit providers and credit reporting bodies has the potential to bring many economic and other public benefits for Australia.

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

These include the following:

- The promotion of better credit management by financial institutions through widening the range and depth of credit information available, and enabling more comprehensive risk analysis to be undertaken. This could be expected to strengthen the prudential soundness of financial institutions and enhance their resilience to economic shocks, thereby making financial institutions safer for depositors and other investors.
- The promotion of greater stability of the Australian financial system as a result of improved financial institution resilience and, potentially, reduced contagion risk.
- The enabling of a more productive allocation of resources in the economy, thereby assisting in the promotion of higher trend growth and reducing the risk of economic instability associated with the misallocation of credit.
- Reduction in the risk of disequilibria in asset markets as a result of excessive lending to particular sectors of the economy. A good example of this may be the potential for enhanced credit data and analysis to assist financial institutions, over time, to better manage their lending secured against residential properties, thereby potentially lowering the risk of residential property price bubbles and the economic and financial instability associated with this.
- Supporting the goal of responsible lending by creating more transparent and comprehensive information on borrowers' credit worthiness and assisting lenders to better assess the ability of borrowers to service a given level of debt. Enhanced credit data exchange may also assist in the monitoring and enforcement of responsible lending by making it easier for regulators to assess the adequacy of a lender's enquiries in relation to a borrower.
- The promotion of a more competitive lending environment, with the potential for a lower cost of credit for lower-risk borrowers. In particular, a more comprehensive exchange of credit data could be expected, over time, to assist smaller credit providers to compete in the credit-providing sector by strengthening their capacity to assess prospective borrowers and tailor credit products and services to particular niche sectors.
- An improved capacity to identify gaps in the credit-providing sector and enable credit providers to develop new or modified credit products and payment services to better meet the needs of borrowers. For example, this could potentially assist in better meeting consumer needs through the development of credit products and services that are more sensitive to particular niches in the credit market, including greater flexibility in the design of terms and conditions of credit.
- The capacity for credit providers to better meet the needs of those currently impeded in their access to credit. Under current credit data exchange arrangements, some persons seeking credit have difficulty accessing funds due to a lack of credit data being available in relation to them. In a more comprehensive credit data environment, there is greater scope for lenders to assess potential borrowers, including those with a limited or impaired credit track record, thereby providing the scope for tailoring lending products to these types of borrowers.
- A reduction in the current level of cross-subsidisation between different risk categories of borrowers that arises from insufficiently granular credit data with which to assess the credit risk of individual borrowers. As a result, over time, more comprehensive credit data should enable better-risk borrowers to obtain credit at lower cost than is currently the case relative to average lending interest rates. Conversely, higher-risk borrowers could be expected to pay a higher rate relative to average credit costs. This more tailored pricing of credit should help to strengthen the incentives for borrowers to better manage their credit risk and financial position, with associated wider social benefits.

ARCA has submitted the PRDE to the ACCC for authorisation of relevant provisions. This provides a very effective vehicle for promoting the exchange of comprehensive credit data between credit providers and credit reporting bodies. In our assessment, it would be more effective and efficient, and less costly for all parties (including government), to promote credit data exchange through an industry-based agreement than to establish regulations in this area. KPMG therefore suggests that the government support the establishment of the PRDE as the vehicle by which credit data exchange can most effectively be promoted.

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

Chapter 4: Consumer outcomes

Recommendation 21 – Strengthen product issuer and distributor accountability. Introduce a targeted and principles-based product design and distribution obligation and Recommendation 22 – Introduce product intervention power. Introduce a proactive produce intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.

The FSI's recommendations relating to customer outcomes are timely, against a backdrop of continuing local and international focus on conduct risk and improving customer outcomes.

The FSI's recommendations focus on some areas that are critical drivers to improving customer outcomes including product governance. The measures relating to product governance are aligned with developments internationally and address some key risks and issues that were identified in relation to product governance for example, the critical need for better post-sale reviews of products. In the past proactive post-sale care of customers has been lacking, therefore it is encouraging that firms will now need to review their products periodically to ensure they are fit for purpose and meet the needs of its customers, reinforcing that product governance is an ongoing process through the product's lifecycle. The challenge will be to recognise the value of this type of exercise as a valuable mechanism to obtain feedback and learnings around consumer outcomes, rather than as another compliance obligation or mandatory process

The introduction of product stress testing is also welcomed as it prompts firms to consider the "what if?" question to understand the risks of products to customers. This is a very demonstrable way of placing consumer outcomes at the heart of product design. Experience of this tool in the UK has demonstrated its usefulness, but advocators should be warned that it is not a panacea – it will never be possible to future-proof a product against all scenarios and circumstances and the FSI as well as the industry need to be cognisant of this before excessive reliance is placed on it.

One notable product governance concept that the FSI report remains silent on however is value for money. Whilst it would be damaging to the industry for this to become a regulator-driven issue, assessing the value for money of products to customers is a critical component in delivering good customer outcomes and in this window of change, it may be a useful concept that the regulator can facilitate the industry to proactively think about. In our experience the key attraction of value for money is transparency of underlying costs to enable a consumer to assess the value.

The FSI recommendations are welcomed, the challenge will now be in bringing these recommendations to life in a balanced way. Implementation needs to be pragmatic – it is clear that the recommendations will impose additional work and complexity on firms to undertake business so it is important that ASIC implement with pragmatism. It is also critical to recognise that whilst the FSI's recommendations will likely go some way to improving consumer outcomes through process and control, for them to be effective, they must be accompanied by a call to action for associated cultural and behavioural change that is truly embedded in firms. Without this, the FSI recommendations could be viewed as regulatory tick-boxes, which would be a poor outcome for all concerned.

Chapter 5: Regulatory system

Recommendation 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.

KPMG supports this recommendation. The proposed new Financial Regulator Assessment Board should assist to strengthen the framework for assessing the performance of regulators and thereby help to strengthen the accountability of the regulators and the cost-effectiveness of regulation. We also support the related proposal for the Government to set out clearly specified expectations of regulator performance, including in respect of the strategic direction of regulation and the tolerance for financial sector risk (ie the balance between financial stability, institutional failure and system efficiency outcomes).

In supporting this recommendation, KPMG suggests that further consideration be given to the following factors:

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

- The Financial Regulator Assessment Board's jurisdiction should be extended to apply to all financial sector regulators, including the ACCC (in respect of the exercise of its powers in relation to financial sector entities) and AUSTRAC.
- The Financial Regulator Assessment Board be required to develop a transparent framework for its assessments, including assessment criteria against regulatory objectives.
- The results of the Financial Regulator Assessment Board's assessments should be publicly disclosed, including any recommendations made in relation to its assessments.
- The Government should specify regulatory objectives and outcomes for all financial sector regulators, with KPIs.
- Regulators should be required to include in their annual reports or other public reports a detailed assessment of their performance against Key Performance Indicators (KPIs).

Recommendation 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.

KPMG supports this recommendation. A more stable funding framework for regulators could be expected to facilitate improved medium term planning and resource management by the regulators. This should be conducive to assisting in the achievement of the desired regulatory outcomes. As recommended by the FSI, it is important that the remuneration reviews be conducted in consultation with industry and consumer stakeholders. This should be part of a wider framework to ensure robust transparency and accountability of regulators. It should be accompanied by statutory obligations on regulators to publicly account for how their funding has been spent, together with external audits of regulator expenditure.

KPMG also supports the proposal for regulators to undertake regular capability reviews to ensure that they maintain staff, systems, processes and infrastructure sufficient to enable them to perform their regulatory functions in a manner consistent with meeting the desired regulatory outcomes. It is suggested that these capability reviews be subject to some form of external, independent scrutiny, either through an external audit process or assessment by the proposed Financial Regulator Assessment Board.

Recommendation 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.

KPMG agrees with the recommendation that ASIC's funding arrangements be placed on a similar footing with those of APRA, such that the Government recovers expenditure related to ASIC's operations via levies on industry participants. However, in adopting this model, it will be important to match the levies to the regulatory costs incurred by ASIC in relation to the category of industry participant so as to minimise cross-subsidisation between industry participants. The levy system should also be designed to ensure that entities that require more intensive regulation or supervision bear the appropriate level of cost associated with this activity. The development of an industry-based funding model will therefore require ASIC to establish and maintain a comprehensive system of identifying and recording regulatory activities by nature of activity, associated cost and industry participant.

KPMG supports a strengthening of ASIC's powers to enable it to meet well-specified regulatory objectives, anchored to specified outcomes. The nature of the powers, the grounds for exercising powers, rights of appeal and accountability arrangements will need to be developed carefully in consultation with industry and other stakeholders. It is essential that the regulatory powers are designed to avoid excessive or poorly targeted regulatory actions, and that ASIC be held to account for any use of its powers.

Recommendation 30 – 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.

KPMG supports this recommendation. However, we suggest that the proposal be modified to take into account not just competition, but also financial efficiency, including the concepts of productive efficiency, allocative efficiency and dynamic efficiency. It is important that regulation be designed to promote a

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

sustainable balance between financial stability, investor/depositor protection and efficiency in all parts of the financial sector as a whole. By including efficiency as a fundamental objective of regulation, this incorporates both the notions of competition and contestability.

We think it would be helpful if the KPIs for regulators included indicators on efficiency, including on contestability and competitiveness considerations, and that regulators be required to report their performance against these criteria (among others). The proposed Financial Regulator Assessment Board would also appropriately include these considerations in its regular assessments of regulators.

Recommendation 31 – 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.

KPMG supports this recommendation. It is essential that regulatory proposals be subject to rigorous cost/benefit analysis and thorough consultation. Stakeholders need to be given sufficient time to evaluate and respond to proposals. Regulators should be under obligations to assess and publicly respond to submissions raised in consultations. All regulatory proposals should be subject to comprehensive scrutiny by the OPBC at an early stage of regulatory development.

We also support regular ex post reviews of regulations. They should be subject to consultation with stakeholders and to independent external scrutiny.

Recommendation 33 – Retail corporate bond market. Reduce disclosure requirements for large listed corporates issuing 'simple' bonds and encourage industry to develop standard terms for 'simple' bonds'.

The recommendation to reduce the disclosure requirements for large listed corporates to issue retail bonds in order to facilitate the development of the retail bond market is welcomed. The driver behind the recommendation is to reduce some of the existing impediments to issuing retail bonds in order to increase the attractiveness of a retail bond offering as an alternative source of corporate funding to the domestic bank market, A$ Medium Term Note market, and also offshore debt markets such as US Private Placement or 144a. In addition, the development of a retail bond market will allow investors access to another asset class in a market where asset allocation is weighted more heavily to equities rather than debt versus the US and Europe.

Over the last three years we have witnessed the emergence of corporate senior bonds being issued based on a simplified term structure similar to the US high yield market, through major participants FIIG Securities and National Australia Bank (NAB) acting as brokers for these transactions. These have principally been undertaken in the sub-investment grade space and could therefore not be referred to as 'simple' bonds, noting also that there is only a limited secondary market available. There is evidence of strong demand from both corporate issuers and retail investors (high net worth individuals and self-managed superannuation funds) for this primary market product and since 2012 there has been over $700m in bond issuances across 13 transactions with the majority of issuers being sub-investment grade with average tenors of 5 years and margins of 400bps over BBSY.

In respect of the recommendation some considerations include:

- Ensuring that the reduced disclosure requirements are not to the detriment of the investor and that the key terms and conditions, and risks of the offer are still appropriately outlined to investors
- Consideration should be given to identification of market makers – being in a position to ensure that the market remains liquid and of sufficient depth to allow market trading activity to occur and investors being able to buy and sell marketable parcels of the investments (debt providers historically have a lower turnover in investments than equity providers, hence the difficulties in previously establishing the market)
- It would be appropriate to consider structuring the issuance in a way to attempt to avoid complicated inter-creditor arrangements for issuers, such as retail bond issuances being unsecured to any senior obligations. The unsecured nature of the bonds (higher risk) and the priority claims of the senior debt needs to be clearly outlined to investors in these circumstances
- Larger corporates generally have the benefit of higher credit ratings and access to multiple debt markets to source financing. In the current market, financing is very liquid for well rated corporates with credit margins (over swaps) having dropped by around 100bps over the last 3 years for BBB rated corporates. Reducing the disclosure requirements alone may not provide the catalyst for increased issuance in the

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

current market as issuers will need to balance the expected investor return requirements on the demand side
- Due to the nature of funding historically provided to fund debt instruments and the elements that determine its pricing (linked to market rates such as BBSW/BBSY and cost of credit risk), any instrument, once listed, has a combination of factors contributing to its current price. Ensuring that any available underlying information (e.g. swap prices) are readily accessible to all investors is important to avoid issues of mis-pricing to the disbenefit of unsophisticated investors
- The credit quality of the corporate issuer is paramount to the cost of debt and represents the risk of default. In order to provide a 'simple' bond product, the probability of default could be determined by the traditional rating agencies (Standard & Poor's, Moody's and Fitch) or a bespoke rating could be generated (similar to the (National Association of Insurance Commissioners) NAIC ratings obtained in the US private placement market)). Any change in the rating will have an effect on the cost and possibly the ability to issue new debt, as well as the depth, market price and liquidity available for existing issuance for relevant corporate issuers. The structure and standard terms of the issuance can account for this if properly designed
- We expect that increased demand for retail bond issuances will occur with issuers lower down the credit curve as available funding options become more limited to issuers and total return to investors increases (in line with risk). This is evidenced by the emergence of the unsecured senior bond market that has had the most demand in the sub-investment grade issuer space, although this quality of borrower may require increased disclosure requirements due to the credit metrics and higher probability of default (and therefore a clear delineation needs to occur as to the merits of issuers that can access any retail bond market)

Recommendation 38 - 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

KPMG supports this recommendation. Australia has a Cyber Security Strategy (CSS) in place, released in 2009, that outlines a whole-of-Government cyber security policy. Submissions indicate the CSS is out of date and not suited to today's threat environment. Given the rapidly changing nature of cyber space and the threat environment, Government should act to ensure Australia has an updated and cohesive CSS.

Whilst industry participants actively monitor the threat environment and are well placed to identify vulnerabilities, the most effective responses come from combining the intelligence they hold with timely threat information held by Government. Consequently, policy and regulatory frameworks need to support and enhance more effective and timely public–private sector information sharing. These frameworks should outline clear lines of responsibility between the relevant government agencies and also mechanisms to enable the effective sharing of information between industry participants and agencies without breaching any relevant legislative obligations, particularly the Privacy Act.

Recommendation 43 – Legacy products. Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.

Costs associated with dealing with closed products continue to be a significant industry issue.

KPMG supports the FSIs proposals relating to product rationalisation for managed investments and life insurance. Specifically, the proposal to build on previous work and develop a mechanism for product rationalisation which addresses existing tax and implementation cost aspects – subject to satisfying a customer 'no disadvantage test'.

The proposal that managers/insurers fund the costs of any new mechanism (for example through an application fee) on a recovery basis is also reasonable.

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015

Contacts

For further information contact details are provided below.

Topic	Key Contacts
Resilience	Andrew Dickinson Ian Pollari Martin Wardle
Superannuation and retirement income	John Teer Sean Hill Bradley Tallents
Innovation	Ian Pollari Mark Tims Gary Gill
Consumer outcomes	John Teer Bernadette Lee Ronna Ludgate Rob Curtis
Regulatory system	Mike Ritchie Geof Mortlock Mark Burgess
Tax	Julian Humphrey Dana Fleming Ross Stephens

© 2015 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International .Liability limited by a scheme approved under Professional Standards Legislation. March 2015