Laying strong foundations

First reactions to the Australian Financial System Inquiry

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Overview

The Financial System Inquiry (FSI) breaks new ground. The standard approach for such reports is to start with the textbook model of the world and then recommend how to move the real world closer to this ideal.

This report does the opposite – it starts with our imperfect real world and asks what can be done to have a reasonable chance of improving it. This is a sharp, and welcome, break from past practice and that alone gives the report a good chance of achieving the roadmap impact of both its predecessors, Campbell and Wallis.

The notion that the world is not a text book is particularly evident in two places.

First, in the discussion around consumer outcomes. The approach to policy over the past 15 years has been dominated by confidence in the benefits of disclosure. Well informed consumers will make the best decisions. Instead, the Inquiry has concluded that in our real world, factors such as imperfect (asymmetric) information and actual consumer behaviour (*This stuff is too confusing!*) require a different approach. Indeed, this is David Murray's paradigm shift. Hence the Inquiry makes recommendations to strengthen product issuer and distributor accountability, and to give the regulator powers to head-off consumer detriment.

The second place is the discussion on stability and bank capital. Once we recognise the world is not a textbook, financial crises become a persistent risk, with especial downside for a commodity-exporting, capital importing country like Australia. It's a short jump to conclude that bank shareholders, rather than taxpayers, should bear these risks and accordingly, Australian banks need to be in the top quartile on a globally comparative basis for capital.

Inevitably, the recommendations around bank capital will attract much scrutiny. Whether you agree with them or not – and broadly we do – it is clear that the capital recommendations reflect the FSI Committee's synthesis of input from global market participants and regulators that bank capital globally is on an upward march and Australia's bias to commodity exports makes Australian banks more vulnerable than generally appreciated. It's not at all clear that was the Committee's hypothesis back in January. The recommendations in respect of pushing forward on international comparability of capital measurement, and for the introduction of a bank leverage ratio, are likewise very important.

Also welcome is the emphasis on the role of superannuation in providing retirement incomes, together with the Report's focus on the importance of achieving political consensus on this. We need the same consensus here as we have for the role of Australia's Reserve Bank, and the end of constant political flip flopping on super. The approach suggested to enhance competition in the provision of default funds – and hence reduced consumer fees – is a sensible combination of carrot and stick, effectively setting a 2020 deadline. The strategy to reduce credit card fees is somewhat more direct.

So what are the major missed opportunities? Even accepting not everything can be covered, it is surprising that a report which aspires to a 10–20 year horizon, carries no mention of looming environmental stresses such as water and climate, notwithstanding the role of the financial sector as the primary risk intermediary in the Australian economy. A different approach to those issues might have seen more attention given in the Report to the insurance industry. Likewise, the Inquiry stuck too closely to the textbook in its discussion of future challenges for bank funding, dismissing those concerns too lightly.

A lot is also being asked of the Australian Productivity Commission, with at least three suggested reviews – financial data, competitive default super mechanism and MySuper. These are three tough and important issues, with the attendant risk that resource constraints mean they are too easily dropped from the agenda.

The onus now shifts back to the Australian Government – it needs to get on with implementation. The challenge will be dealing with stakeholder criticisms about specific recommendations in a fair way without sucking 2015's oxygen from the really important and difficult issues facing Australia, especially taxation reform, productivity, and federal-state fiscal relations.

Potential impact in New Zealand

The recommendation for a more conservative capital regime in Australia may not have direct implications for New Zealand's banks given our banks already operate under an adjusted prudential regime with risk weighted asset adjustments in place, at this time.

However, these recommendations may have ripple effects for the New Zealand subsidiaries of Australian banks and, potentially, other financial services. Exactly how these effects will be felt within the New Zealand market will take some time to become evident.

In relation to stronger capital requirements to withstand another financial crisis, the Inquiry believes the capital ratios of Australian banks should be ranked in the top 25 per cent of global banks. Also, a process for more transparent reporting of comparative capital ratios should be developed.

The major Australian banks are currently somewhere between the global median and the 75th percentile.

Furthermore, the recommendations call for the Australian Government to introduce a leverage ratio as a backstop to Authorised Deposit-Taking Institution's risk weighted capital positions – in line with standards outlined in the unfinished Basel III agenda.

Internationally, total loss absorbing capital in the region of 16 to 20 per cent is being sought, including regulatory capital. Australia's largest banks currently hold 12 to 13 per cent total regulatory capital. The Inquiry clearly states that deposits should not form part of the loss absorbing capital.

Here, the Reserve Bank of New Zealand has an Open Bank Resolution policy, where a distressed bank is kept open for business and the cost of a bank failure falls primarily on the bank's shareholders, rather than the taxpayer.

If losses cannot be covered by shareholders and the bank's available capital, then in addition, a proportion of depositors' funds are set aside and frozen for this purpose to enable bank services to resume, whilst an appropriate long-term solution to the bank's failure is identified.

In the residential mortgage arena, Australian recommendations call for narrowing the gap between Internal Ratings-Based Approach, which allows qualifying banks to estimate their own risk parameters for the purpose of calculating regulatory capital, and standardised model risk weights for housing loans by increasing the former to between 25 and 30 per cent. If adopted, this has the potential to lead to a small increase in the cost of funds for the major banks.

Financial system resilience

> ***"The Inquiry has recognised that retaining trust and confidence in the financial system is paramount to supporting economic growth."***

As expected the Inquiry has made significant recommendations in relation to financial system resilience, in particular for bank capital.

Recommendations include:

- Setting capital standards such that Australian ADI capital ratios are unquestionably strong. In practical terms, this means ensuring Australian banks sit in the top quartile by international comparison.
- Raising the risk weights for mortgages held by the internal ratings based (IRB) banks to be closer to those used by standardised banks. Currently IRB banks' mortgage risk weights are around 18 per cent on average. The Inquiry, whilst not quantifying a preferred floor talks about moving towards a 25 per cent risk weighted asset floor for mortgages.
- Implementing a total loss absorbance and recapitalisation framework in line with emerging international practise to ensure orderly resolution should a bank fail. Internationally, total loss absorbing capital in the region of 16–20 per cent is being sought, including the regulatory capital. Australia's largest banks currently hold in the region of 12–13 per cent total regulatory capital. The Inquiry clearly states that deposits should not form part of the loss absorbing capital. The Inquiry also recommends that work on crisis management planning continue in conjunction with this recommendation.
- Developing a reporting template for Australian banks that is transparent against the minimum Basel capital framework.

What is the reasoning?

In essence, the Inquiry recognises that retaining trust and confidence in the financial system is paramount to supporting economic growth, given the Australian economy's interconnectivity and reliance on international funding. The recommendations focus on making sure the financial system can withstand plausible shocks, rather than ensuring financial crises can never occur. At the same time it promotes keeping in step with the broad themes of international regulation.

The recommendations relating to risk weighted assets have a dual purpose of ensuring sufficient capital for systemically significant banks and of levelling the playing field by increasing the level of capital held by big banks to something closer to the smaller banks.

As expected, the Report includes a substantial discussion about where the Australian major banks currently sit on capital relative to global banks and about the complexity of making such comparisons. The challenge of making these comparisons is much better understood today as a result of the Inquiry process, and we particularly welcome the recommendation that a reporting template be developed for Australian banks that is transparent against the Basel capital framework.

For instance, a lot turns on whether items are adjusted to minimum Basel rules or also adjusted for differences in implementation of the rules by national regulators, but still within the Basel framework. This remains one of the key factors underpinning different estimates of capital requirements, including those by PwC. We certainly don't accept the Inquiry's view that comparisons based on adjusting for national differences that go beyond the Basel minimums are not a plausible basis for international comparison.

There was some debate about whether the Inquiry would adopt a principles-based approach or be more prescriptive in respect of capital; in adopting a principles-based approach it has undertaken the prudent path.

As noted on pages four and five, we support the broad approach set out by the Inquiry in respect of capital. In an uncertain world, it is a prudent approach.

This of course now leaves the task for APRA to decide how to respond. All the debate thus far about the existing position on bank capital only highlights the practical challenges which the regulator will have in deciding if and how to proceed. The Inquiry's intention appears to be to apply these principles to all Australian banks and this will only increase this challenge.

"The challenge of making international comparisons is much better understood today as a result of the Inquiry process."

Consumer outcomes

The consumer outcome recommendations are almost entirely underpinned by a desire to address the needs of consumers at every point of the product development and distribution lifecycle – a paradigm shift away from the reliance on point of sale measures like disclosure, financial advice and consumer financial literacy.

“The inquiry has clearly signalled a substantial shift in terms of how financial services interacts with consumers.”

This is most stark in the Inquiry’s recommendation to strengthen product issuer and distributor accountability – at first blush, the most radical of developments from the interim report.

The Inquiry recommends the introduction of a targeted and principles-based product design and distribution obligation, requiring product issuers and distributors to explicitly consider the needs of the type of consumer who would buy the product and the channel best suited to distributing it.

In this model, obligations would arise:

- during product design – identification of target and non-target markets, stress testing products for consumer impacts under different circumstances, testing key features with consumers
- during the distribution process – requiring issuers and distributors to put controls in place to govern how products are distributed
- after the sale of the product – periodic reviews to ensure products still meet target market needs and distribution remains consistent with the product’s risk profile.

The Inquiry argues that this recommendation should not stifle innovation but rather ensure it appropriately targets consumer needs. Further, the Inquiry has stated that a principles-based rather than prescriptive approach will allow firms to adapt existing practices at minimal cost.

It must be said these claims seem optimistic given the very recent memory of the costs of implementing Future of Financial Advice (FoFA) which ran to hundreds of millions of dollars. Likewise, as FoFA has shown, loading greater cost and regulatory complexity into the product distribution system is not necessarily in the best interests of consumers and can lead to unintended consequences such as a more challenging competitive environment for non-vertically integrated providers.

The Report otherwise largely keeps faith with the headline proposals from the Interim Report with the key recommendations including:

- providing ASIC with a proactive product intervention power enabling action to be taken at a product level where there is a risk of significant consumer detriment

- removing regulatory impediments to innovative product disclosure and communications, and improving the way risk and fees are communicated to consumers
- modifying the carve-out of life insurance commissions from the ban on conflicted remuneration – limiting upfront commissions to the level of ongoing commissions
- strengthening minimum standards of adviser education and professional development
- establishing an enhanced public register of financial advisers that includes more detailed disclosure of the individuals' overall qualifications, expertise and experience
- increasing ASIC's powers including a power to ban individuals from managing a financial firm
- reviewing the stockbrokers' exemption to the conflicted remuneration provisions
- renaming general advice and requiring advisers and mortgage brokers to disclose ownership structures.

Challenges for implementing policy

Recommendations to introduce higher adviser education standards are likely to be relatively easier to implement, given the support these measures have received from ASIC and the industry more broadly. The measures to enhance the impact of disclosure are also hard to argue with and have already received endorsement from much of the industry and consumer groups. As little legislative change is likely to accommodate these recommendations, chances of a green light seem good (though the difficulty of finding workable solutions can't be underestimated).

Increasing funding and powers for ASIC makes sense and, in theory at least, is ripe for bi-partisan support given the obvious consumer benefits of a well-funded and functioning regulator.

Changes to the way products are developed and distributed, reframing of the general advice rules (something that no doubt will require more than just a change in terminology), in addition to changes to the conflicted remuneration rules will be much more challenging. The opportunity here is that the Inquiry's independent work can be used as a much needed circuit breaker, notwithstanding the practical cost and other challenges mentioned on page eight.

> ***"Increasing funding and powers for ASIC makes sense and is ripe for bi-partisan support given the obvious consumer benefits of a well-funded and functioning regulator."***

Superannuation and retirement incomes

The primary objective of the superannuation system, as stated by the Inquiry, is to provide an income in retirement to substitute or supplement the Age Pension. The Inquiry seeks broad political agreement for this objective, including seeing it enshrined in legislation.

Reducing superannuation fees will help meet this objective. The Inquiry has reservations that the existing Stronger Super reforms will reduce superannuation fees to efficient levels. It recommends that unless substantial fee reductions are delivered by 2020, a new competitive mechanism should be established. Under this recommendation:

- a small number of providers would be selected to be the default fund for new workforce entrants through a mechanism such as tender or auction
- those people that already have a superannuation fund would retain that fund
- funds would retain members through all employment changes until the employee selects a different fund.

The Inquiry recommends the Productivity Commission start work on the mechanism in 2015.

For the retirement phase, the Inquiry recommends superannuation trustees be required to offer retirees a comprehensive income product in retirement (CIPR) that provides an appropriate mix of income, flexibility and risk management. To increase use of these products, the superannuation fund will actively contact the member on retirement with pre-selected CIPR which are subject to the member's opt out.

On governance, the Inquiry recommends mandating a majority of independent directors on the board of corporate trustees. On direct borrowing, the Inquiry recommends removal of the exception allowing smaller funds to enter into direct borrowing for limited recourse borrowing arrangements.

What is the reasoning?

The recommendation of a system objective of providing for retirement income is designed to repair the current lack of an agreed policy framework, which contributes to short-term ad hoc policy making and undermines confidence in the system.

The Inquiry notes several indicators that competition is failing to reduce superannuation fees. In particular, two-thirds of the estimated benefits from scale and lower margins over the past decade have been offset by increases in fund costs. The Inquiry has reservations about whether the Stronger Super reforms will reduce fees through competition. A review in 2020 allows industry time to evidence the efficiency and effectiveness of the Stronger Super reforms as MySuper products will have been in force for up to four years.

Lump sums and account-based pensions, the major way superannuation balances are drawn down, do not smooth consumption through retirement, and expose retirees to risks. The Inquiry recognises there is a lack of demand for retirement income products and a gap in the suite of products offered. The proposed use of defaults to increase take up of a CIPR reflects the lack of guidance currently provided on reaching retirement. People have a strong status quo bias, so the offer of a default retirement income product could have substantial effects on retirement decisions.

What is surprising about these recommendations?

The intent to de-politicise the superannuation system may be surprising to some, but it was a theme across submissions and fits with the Inquiry's objective of designing a road map for the future.

Whilst the interim report outlined the range of reforms the Inquiry was considering in relation to superannuation and retirement incomes, it is a little surprising to see where they have landed. In each case they have landed on the middle of the road option, allowing industry time to deliver efficiency outcomes, and preferring to nudge retirees towards making better decisions for their retirement.

What are the challenges to implementing these policy recommendations?

In terms of depoliticising the superannuation system, the most obvious risk is the inability to achieve bipartisan support.

On improving efficiency, the pending review of superannuation fees will create uncertainty for the industry about whether there will be a shift to yet another framework. Designing the competitive mechanism will also be difficult as there is a need to:

- design the mechanism such that fees alone do not drive the outcome and so that insurance and investment strategies are not adversely impacted, which could result in lower net returns
- select funds that will deliver superior net returns, despite previous returns not being evidence of future performance
- spread the benefits of competition for new default members to existing members
- retain an active pool of competitors for future rounds of the mechanism.

For Government, the provision of attractive retirement products will require policy settings to be calibrated across several areas outside the scope of the Inquiry. These include taxation, the superannuation preservation age, pension settings and other barriers to development of the annuity market. In their absence, attempts to nudge people into particular products may not be successful. Trustees will also require time to design these products and potentially form alliances with other providers.

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Innovation and payments

Innovation: *The Inquiry recommends the Australian Government establish a new public-private consultative body, the Innovation Collaboration, to identify opportunities for innovation and emerging network benefits in the financial system.*

Many submissions to the Inquiry identified lack of government awareness of impediments to innovation. There is no coordinated forum for innovators to influence government or assist government in identifying innovative opportunities. The Innovation Collaboration is designed to fill this gap.

The Inquiry also recommends the Australian Government develop a national strategy for a federated model of digital identity providers. The strategy would set out the standards under which identity providers would compete to supply trusted public and private digital identities. The need for a national strategy for digital identity is driven by previous coordination failures in the financial services sector. Digital identity management remains duplicative, onerous and costly. The choice of a federated digital identity model is sensible given public scepticism of a single government credential, as was shown with the Australia card.

In one of several bodies of work proposed to be handed to the Australian Productivity Commission, the Inquiry has recommended the Commission examine the costs and benefits of improved access to and use of financial data and whether it could lead to the development of alternative business models, products and services.

The Inquiry also sought to create some space for the development of new payments and crowdfunding innovations through gradation of regulation to provide a lighter regulatory environment for new entrants.

What are the challenges to implementing these policies?

The recommendations relating to innovation contain few surprises except that emphasis has been placed on government regulation and facilitation of industry opportunities, rather than stimulating Australia's international competitiveness in financial technology.

The Innovation Collaboration may be an effective lobby point, and may facilitate banks working together. However, given the Inquiry has a goal of supporting the growth of the Australian economy, the Report is limited in stimulating innovation for Australian financial services companies to be disruptors in the Australian market and internationally. Major financial services providers in Australia are not emerging to take this role due to strong domestic performance and profit, and their legacy systems and decision processes.

Developing the Innovation Collaboration into an effective body will be a substantial challenge. To be effective, it will need to include the right combination of public and private sectors and emerging innovators, it will need to publish mechanisms and metrics to ensure effectiveness, and it will need to develop outputs which will influence government policy.

The desire for gradation in payments and crowdfunding regulation may provide some scope for innovative developments absent the constraints of regulation. However, regulators will be challenged in setting the gradation at a level that does not bind too soon but provides the protections that the regulation is designed to provide.

Payments: The Inquiry's recommendations could provide large benefits for small business by recommending interchange fee regulation be extended to cover all amounts paid by customer service providers (typically a cardholder's bank) in payment systems.

These payments include interchange fees, service fees and companion card systems, and incentive payments. The Inquiry also recommends that interchange fee caps be lowered and all transactions be subject to hard caps, rather than the weighted average caps currently applied.

The extension of interchange fee caps reflects the Inquiry's belief the existing caps have improved the efficiency of the payments system, and will improve competitive neutrality between providers of similar services. The lower interchange fees and hard caps will also reduces cross-subsidisation between users of low and high-cost cards, and between small business and large businesses, who typically have more bargaining power with payment providers.

The campaign to ban surcharging, which generated over 5,000 submissions to the Inquiry, had some success. The Inquiry recommends that surcharges be capped under a three-tier system. Low cost payment system providers would be able to prevent merchants from surcharging, medium cost system providers would be subject to surcharge limits set by the Payments System Board, whereas high-cost system providers could apply reasonable cost-recovery rules.

As for the interchange fee measures, the rules concerning surcharging will reduce cross-subsidisation between users of low and high-cost payment methods. The recommendation is designed so that the surcharge reflects the cost of the payment method.

What are the challenges to implementing these policies?

The increased regulation of interchange fees and surcharging could result in a substantial loss of revenue for high-cost payment providers. Businesses for which payment surcharging is a material source of revenue will also be affected by the strength of the recommendations.

The Payments System Board regulates payment systems. As a result, the recommendations relating to payments are not directly in the hands of government, with implementation subject to the views of the Board.

"The Inquiry recommends that surcharges be capped under a three-tier system."

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