Institute of Chartered Accountants Australia

31 March 2014

Head of Secretariat
Financial System Inquiry
The Treasury
Langton Crescent
Parkes ACT 2600

By email: fsi@treasury.gov.au

Dear Committee members

Financial System Inquiry – Submission in line with the terms of reference

The Institute of Chartered Accountants Australia (Institute) welcomes the opportunity to provide a submission in line with the terms of reference of the Financial System Inquiry (the Inquiry). Appendix A includes more information about the Institute.

Key points

- Greater stability of the financial markets

Regulation and supervision of the financial markets needs to be proactive in identifying and preparing for the next big shockwaves to the global economy, wherever it might come from, rather than looking to provide a retrospective fix. Aspects for further consideration include the value of integrated reporting and enhancing the communication of a broad range of risks.

- Building trust and confidence in the financial system

Trust is key to deliver a higher level of engagement between consumers, their savings and their overall financial position. The primary responsibility to rebuild this trust lies with the financial services providers. Assurance and corporate governance can play a key role in rebuilding the trust and there is a need to increase financial literacy in society.

- Enhancing Australia's international competitiveness

Fostering a stronger innovation culture across Australian businesses, along with improvements in productivity outcomes will be key drivers of Australia's ability to become a competitive market economy in the future. Regulatory settings must therefore support those objectives, not work against them. The imputation system and corporate tax rate will need to be considered for the forthcoming tax system white paper.

- Fiscal sustainability

Australia is one of only a handful of nations that currently enjoys a AAA credit rating. However pressures are emerging to the fiscal position, through narrowing tax bases and increased expenditure. Policy outcomes which deal with these pressures are needed. Specific recommendations include the need for tax reform

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to prevent further adjustments to the superannuation sector, a review of the retirement age and encouraging greater financial independence.

- Boosting productivity and cutting red tape

A policy environment that both enables and supports productivity growth must be supplemented by a comprehensive and ongoing program of wide-reaching reform. Any attempts to reduce red tape should be implemented in a holistic manner without jeopardising productivity, innovation and investment, but at the same time acting in the interest of all Australians. Technological solutions (i.e. an 'e-government' approach) should be sought to reduce regulatory burdens that cannot be eliminated. Initiatives such as the government's Cutting Red Tape website is an approach that is seeking to reduce regulatory burden and the Institute looks forward to the outcomes of this initiative.

Further, we consider it important that the Inquiry is staffed for a couple of years following the delivery of the final report to enable recommendations to be followed through and implemented in a collaborative way with relevant stakeholders. We have included our detailed comments and recommendations in the following submission.

Should you have any queries concerning the matters discussed above or wish to discuss them in further detail, please contact me via email at: lee.white@charteredaccountants.com.au; or by telephone on 02 9290 5598.

Yours sincerely

Lee White
Chief Executive Officer

Institute of Chartered Accountants Australia's Submission to the Federal Government Financial System Inquiry

1- Lessons learned from the past

The Inquiry's objectives are to examine how the financial system could be best positioned to meet Australia's evolving needs and support our nation's economic growth. We note that since the Wallis Inquiry, there have been a number of key events which are relevant to shaping the outcomes of this Inquiry.

1.1 Regulators

Overall, the 'Twin Peaks' of the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA) have been successful. However, we note the regulatory environment is broader than these two bodies and therefore there is a risk of cross-over, lack of clarity and different approaches.

Recommendation 1: The Inquiry consider a review of the respective roles of ASIC, APRA and ASX to ensure there is not significant duplication of oversight and identify whether any clarity of their respective roles and boundaries is needed. We also note that if, as a result of the Inquiry, there are recommendations for these regulatory bodies to have greater expectations placed on them, they will need to be resourced appropriately.

The ATO is the regulator of the self-managed superannuation fund (SMSF) segment, which makes up more than a third of the superannuation savings in Australia. The SMSF segment represents a different model from APRA regulated funds and as such, does not require prudential regulation. The Institute largely supported the findings of the 2010 Cooper review into Australia's superannuation system in which the SMSF segment was identified as largely successful and well functioning.

Recommendation 2: Any further substantial regulation around the SMSF segment is unwarranted, creating artificial barriers to those wishing to control their own superannuation savings.

1.2 Global capital markets

Over recent years, many global economies have experienced significant and damaging effects resulting from the global financial crisis which has resulted in millions of investors losing money in capital markets and secondary markets due to over-leveraging of gearing facilities and opaque corporate structures. The Global Financial Crisis (GFC) has taught us that Australia's financial system is closely linked to the global system, particularly through its dependence on wholesale funding. Further, the whole system is vulnerable to global shocks and Australia is not immune to the impacts of these.

Recommendation 3: In learning from the GFC, the Inquiry needs to both consider where the next significant global shock might come from and how Australia's financial system can be prepared for it.

1.3 The impact of financial collapses

In recent years, we have seen domestically significant corporate and product collapses including Trio Capital and Storm Financial. This has resulted in many investors losing money in capital markets and secondary markets due to over-leveraging of gearing facilities and opaque corporate structures. These factors over time have combined to deliver a general decline in consumer confidence and trust in markets.

As assets grow through the compulsory superannuation system (for some individuals, this may well be their largest asset) there is a greater focus on the need for stability, (and certainty), in the financial services industry. Improved trust is necessary to deliver a higher level of engagement between consumers, their savings and their overall financial position.

While there has been a focus in recent times on ensuring that the provision of financial advice to consumers is delivered within a strong regulatory framework, improving community trust in the financial services industry must be a key focus for this inquiry. The responsibility to build this trust depends primarily on financial services providers, but consumers also have some responsibility. Currently, consumer responsibility is limited by low financial literacy due to the complexities of what individuals believe they need to know. Consumers – in the majority of cases – are simply looking for a trusted source of advice, to provide guidance on their obligations as well their entitlements under various policy frameworks. Additionally, we note regulators have a role to play in supporting trust in the markets. When communicating with the public, issuing blanket statements about certain matters can erode trust. Instead, messages should appropriately highlight the difference between systemic issues and individual or one-off issues.

Recommendation 4: The Inquiry needs to look at how it can build trust and confidence into the system. Key areas for focus include the role of assurance and corporate governance as well as increasing an individual's financial literacy and access to quality financial advice.

2- System developments since Wallis Inquiry

2.1 Financial claims scheme

As a result of the GFC, it was necessary for the Australian Government to act as a guarantor for bank deposits to protect the system. Whilst the wholesale funding and large deposit guarantee scheme is closed to new liabilities, the financial claims scheme still exists for individuals of up to $250,000 per customer per institution. Additionally, the financial claims scheme, combined with a loss of trust and confidence noted earlier, is significantly impacting investment decisions. The scheme enables individuals to invest large sums across a number of financial institutions in risk free term deposits. It also impacts other institutions not covered by the scheme but offering similar longer term products, such as annuities. Those institutions covered by the scheme have greater access to risk free funding at lower costs via increased customer deposits than other institutions, which impacts competition in the market.

Recommendation 5: We recommend that the maximum amount covered by the financial claims scheme be reviewed as well as consideration of a fee for guaranteeing amounts in excess of that balance.

2.2 Financial services industry structure

Today's structure of the financial services industry and provision of advice has resulted in a vertical integration model that is dominated by the major financial institutions. With more than 80% of financial advisers operating under an Australian Financial Services Licence (AFSL) of an institution, we consider there would be value in the Inquiry reviewing whether this is the appropriate model long term. In particular, the Inquiry should determine whether the delivery of sound financial advice is adversely impacted by potential conflicts arising from these vertically integrated models.

Further the last decade has seen a growing consolidation in the provision of advice. As a consequence there has been a significant decline in the competition within the industry. A greater level of competition would provide consumers with a wider choice of providers. One argument is that longer term, the provision of advice could be aligned with other professions with registration/ licensing on an individual basis as opposed to operating through a corporate structure. A thorough review of the advantages and disadvantages of developing what would be a significantly different model should be considered.

Recommendation 6: With the proposed amendments to the Future of Financial Advice (FOFA) reforms being put on hold for further consultation, it is important to settle on regulation that while protecting consumers, is both practical and designed to last. The ongoing debate over the FoFA reforms is not assisting in delivering one of the original policy objectives – to improve the trust and confidence in the financial services industry.

2.3 Tax reform and tax red tape

Despite the difficult fiscal position, there has been a lack of action around GST and tax reform more generally. Without the right tax framework in place, increasing fiscal pressures can adversely impact the financial system.

Recommendation 7: The Inquiry should consider whether the current income tax rules dealing with the Taxation of Financial Arrangements (TOFA) and collective investment vehicles can be further improved and their administration simplified. The remaining Federal and State imposts which inhibit the efficient working of the financial system and reduce Australia's competiveness as a financial centre should also be reviewed.

Recommendation 8: The Inquiry should consider the need for new, tax effective financial products which promote individual self-sufficiency (e.g. aged care saving bonds) and desirable economic activity such as infrastructure spending.

Recommendation 10: Substantial tax data collection obligations are imposed on the financial services industry, and it is expected that this burden will increase as part of moves by the United States and the OECD to obtain data on cross-border financial transactions. The Inquiry should consider ways in which this burden can be alleviated.

2.4 Uncertainty in superannuation

Further, the continual uncertainty around superannuation planning is having a significant impact on the psyche of ordinary Australians. We would caution against further frequent small changes to the superannuation system in the short term. The super system has been used as a budgetary tool each year by subsequent governments. This, together with recent extensive reform, has resulted in a significant loss of confidence by the Australian community. Compulsory super will not be sufficient for most Australians to achieve adequate savings for retirement; additional voluntary contributions are necessary and this will only happen if people feel secure about locking their money away until they retire. A successful retirement incomes system can only be achieved if the superannuation system is one in which people have confidence.

2.5 Small business growth

With the small business sector employing millions of Australians, the economic benefit of a strong and confident small business sector is vital. Regulatory efficiency and confidence will ensure the long term strength of this sector. The proliferation of state and local regulations has a significant impact on small business. Each regulation can require a slightly different approach, compliance model, report or assurance report. For a small business owner to determine which regulations apply to their individual business and how to comply with them is time consuming, costly and diverts scarce resources from innovation and productivity.

Integral to the small business sector is the advice and services framework they access. Traditionally the primary source of advice broadly, for small business, is their accountant which allows the small business owner to focus on their area expertise which is running the business as opposed to the administration, regulatory and compliance requirements of a small business.

Anecdotal evidence suggests that family businesses tend to be more risk adverse, and have a desire to retain greater control over their business affairs than non-family businesses. This is reflected in their appetites for credit, with greater use of bank finance and lower use of external sources of equity finance. Like many SMEs, the ability of a family business to access bank finance is often dependent on their ability to offer property as security. Usually it is the value of these assets that determines access to capital, not the success or viability of the business. Business finance has been difficult to access for many businesses, with banks in the current economic environment tightening eligibility requirements.

Recommendation 11: The Inquiry should canvass ideas for innovative ways of raising finance for small business and other start-ups.

3- Drivers for the future

3.1 Demographic changes

The Inquiry needs to consider the demographic changes Australia is expected to experience over the coming decades and examine how the financial system needs to change to best meet the challenges from these changes.

An aging population means a full assessment of our retirement incomes system is needed to ensure sustainability for future years. It is critical for the system to encourage financial independence and alleviate demands on government funding in future.

Apart from the fiscal implications for the Government in funding a population with a significantly greater proportion in the over 65 year age bracket, the provision of quality financial advice will become more vital. In recent years we have seen greater numbers of Australians who are not only living longer but unfortunately succumbing to a different range of illnesses that require medical attention. For example, the onset of dementia related illnesses and the need for 'high care' services to the aged has been flagged as a significant issue that will need to be addressed over the coming years. Those dealing with issues of mental incapacity or requiring specialised care will need specialist advice. It is therefore vital to ensure the cost effective and independent financial advice is available to all Australians.

In addition, the workplace will become more transient in nature as younger workers are expected to have a number of careers in their working life rather than a job for life. This could also result in less job security in the future. They are also likely to be starting their working life with large debts from higher education. The impact of these on availability of finance and superannuation contributions for young workers needs to be considered as part of the Inquiry.

The link between employment and superannuation has resulted in a significant gap in retirement savings for those, particularly women who are more likely to have broken work patterns, time out of the workforce and undertake part-time work. Further, the wage gap between men and women is 17%.These issues could be considered a consequence of the disconnect between the superannuation model and society's traditional family values. However, whilst there has been an increased focus in recent years of increasing female workforce participation, there remains a significant gap. In 2013, the Australia Institute found women ended up with about 59 per cent of the superannuation of men at retirement age. The Inquiry will need to consider what part the financial system should play in closing this gap and how that might be achieved.

Recommendation 12: An ageing population will increase demand for health and aged care resources and its financial implications. In respect to this, consideration needs to be given to the insurance industry, particularly health insurance and how to achieve the appropriate balance between the social responsibility of government to provide services and the responsibility which should lie with the private sector and the individual.

3.2 Technology

From a technological perspective there is greater access to financial products and services online via the internet. There is no doubt many consumers will adapt to the provision of these products from this distribution channel and a certain proportion will engage in a DIY approach to managing their finances. However, while this is the case, the need for professional advice will also need to increase proportionately on many levels. Consumers' knowledge and engagement will continue to improve, at the same time the complexity and longevity needs of their financial position will need to be addressed.

The automation of transactions increases the efficiency of the financial system as a whole. However, technology also gives rise to different security risks as people no longer carry cash and cheques, but instead rely on cards and internet banking for automated transactions. As the proportion of electronic transactions increases, especially on an international basis, there is a greater risk of an individual's financial information and identity being compromised. The Inquiry will need to look at how to balance these risks whilst keeping pace with the growth and efficiency of the use of technology.

3.3 Increase in superannuation

Already, superannuation makes up a significant proportion of investment in Australia. As at December 2013, superannuation assets totalled $1.8 trillion having experienced 19.8% growth in the prior twelve month period. The compulsory component of superannuation means that it will continue to grow and this growing amount of money needs to be invested. It will be important that funds have the ability to invest in diversified and quality investments to look after the members' best interests. The Inquiry will need to consider the impact should these funds continue to be channelled into traditional shares, cash and property. An increase in overseas investments could increase the risk for members as the regulation and governance in overseas jurisdictions may be less stringent than in Australia. Further, the risk of property bubbles developing needs to be considered.

The SMSF segment currently accounts for nearly one third of total assets in superannuation. By 2033, SMSFs are expected to hold $2.23 trillion out of a total estimated super pool of $7.6 trillion[1] The unique aspect of the SMSF segment is that the assets are spread over more than half a million different entities. Therefore, while it will be important to address the issue of available assets for superannuation investment, it will be equally important to ensure the SMSF segment has the ability to invest in new and different asset classes. Their individual size may prove prohibitive for certain investments where the ability to pool resources will potentially enable a new source of funding for investments.

As noted earlier, we support the findings of the 2010 Cooper review and we raise the issue of borrowing within superannuation for consideration by the Inquiry. The Cooper Review panel did not believe that borrowing was consistent with Australia's retirement incomes policy however they declined to make a specific recommendation on it due to legislation allowing borrowing being relatively new and government announcements to introduce greater consumer protection mechanisms. They did however recommend a review of borrowing to occur within two years of their report. This review has not occurred. Regulators and others have raised concerns around different

[1] Deloitte Actuaries and Consultants "*Dynamics of the Australian Superannuation System. The Next 20 Years: 2013 – 2033*"

aspects of borrowing including its impact on the housing market. The Institute strongly encourages such a review to occur – firstly to ascertain whether borrowing in super is appropriate or not and secondly, if it is, then to ensure we have the right legislative and regulatory framework around it.

Recommendation 13: The Inquiry will need to look at ways of facilitating and encouraging alternative investment vehicles. This may include the removal of impediments to further growth and consolidation, for example, reviewing the tax consequences of funds merging. Section 4.6 below contains further details on alternative investment vehicles.

4- Policy recommendations

4.1 Building trust and confidence in the financial system

Trust is key to deliver a higher level of engagement between consumers, their savings, their overall financial position and the financial services industry. The responsibility to rebuild this trust lies primarily with the financial services providers. Assurance and corporate governance can play a key role in rebuilding the trust and there is a need to continue to increase financial literacy in society.

<u>The role of assurance</u>

The next few years will continue to see rapid change in business environments and markets. Audit and assurance will play an important role in maintaining the strength of Australia's financial and business markets, while supporting financial integrity in society. The Institute's 2012 publication *Preserving capital market confidence through audit quality*[2] noted that quality external auditing is integral to capital market confidence and the financial statement audit is the linchpin for upholding confidence in the capital markets.

Business flourishes when supported by a clear, simple but effective regulatory environment. In relation to audit and assurance, Australia has been a leader in global convergence. The Institute supports this but recognises that Australia doesn't always need to be first mover. Over the next few years there will be many overseas proposals and ideas in relation to audit regulation. While Australia is a mature capital market, in some ways similar to the UK, US and some European markets, many of the proposals which will be put forward in those markets are predicated on the economic position some countries are facing. These economic conditions have not eventuated in Australia. It should also be recognised that Asian markets are an important future focus for Australian business. Australia must guard against pricing itself out of future markets by being too complicated or costly to do business.

Outside of capital markets, Australian business and competiveness can be enhanced by the provision of independent assurance. This provides a stronger basis for decision making and a stronger economy. Keep regulation simple and use the Auditing and Assurance Standards Board (AUASB) or professional bodies to provide structure and detail. This will not only provide a stronger more robust regime, but also limit the cost to business. Unnecessary cost arises where regulations provide for different criteria or regimes – business needs clarity and certainty to flourish.

The provision of independent assurance other than on financial statements is increasingly seen as a necessary and effective option for business growth. Outside of Australia, there is growth in the demand for assurance over an entity's sustainability and other similar reports. BASEL III for the financial services industries for example, includes requirements for independent assurance. Other new proposals, such as the OECD Base Erosion Profit Shifting (BEPS) project, are often data intensive place reliance on the data. Assurance has an important role to play in these instances.

As noted in relation to financial statement audit, business flourishes when there is certainty and clarity, and costs are reduced when there is consistency.

[2] *Preserving capital market confidence through audit quality* (2012) Institute of Chartered Accountants Australia, www.charteredaccountants.com.au/~/media/Files/Industry%20topics/Audit%20and%20Assurance/PreservingCapitalMarketsfinal%20version051012.ashx sourced 12 June 2013

Recommendation 14: The Inquiry should devote some time to understanding the issues and value of the role of assurance. With appropriate advice from key stakeholder groups, this will allow formulation of an approach to best support and promote the role of assurance through a simple regulatory framework which will drive effective and efficient markets for Australian businesses.

Corporate governance

Governance plays an important role in the integrity of the financial system. A system of good corporate governance plays a vital role in allowing Australian corporations access to capital in global markets. The Australian Securities Exchange's Corporate Governance Council (CGC) Principles and Recommendations are important in establishing and maintaining investor confidence in Australia's public companies and markets. Although they are principles based, there has been a high level of reporting and compliance by Australia's listed entities. Principles based requirements provide flexibility for corporations to implement the Principles and Recommendations in a way that reflects the size and nature of their structure. The Principles interact with existing requirements within the *Corporations Act*.

While Australia's corporations have been well served by the CGC Principles and Recommendations, they do not apply to all entities in the financial system and there are increasingly other players setting requirements. In recent years the Government has sought to utilise legislation to deal with some corporate governance issues particularly around executive remuneration. APRA also mandates certain governance requirements through its Prudential Standards.

While APRA's Prudential Standard on Governance applies more widely than the CGC Principles and Recommendations, it is framed around a more narrow definition of corporate governance. This brings differing requirements and levels of transparency around corporate governance arrangements depending on the type of entity and which governance structures apply to it.

The ASX released the third edition of the CGC Principles and Recommendations at the end of March 2014.

Recommendation 15: At a minimum, APRA should review its Prudential Standard on Governance against the updated Principles and Recommendations to ensure it remains relevant and in line with current best practice governance arrangements.

It is important that governments do not seek to increase existing compliance obligations and red tape for business. Where a corporate governance issue does not require the backing of the force of law through penalties, principles based requirements should be utilised. This will reduce the regulatory burden for many organisations and lead to lower compliance costs. With many of Australia's listed entities competing on a global scale, it is important that Australia's compliance costs are not placing them at a disadvantage.

Financial literacy

While there is a growing view that consumers need to take greater responsibility in their financial position and engage with it, the issue of low financial literacy is still prevalent. The consequences of low financial literacy are twofold. Firstly this lack of financial literacy results in many consumers being unable to make appropriate financial related decisions themselves ,and secondly as a result even when consumers access professional financial advice they are still challenged in understanding the actual advice being provided. For example following the Wallis inquiry a range of new disclosure requirements were developed to assist consumers, such as Financial Services Guides and Statements of Advice. As the industry has moved through the recent GFC there would be value in appropriately considering the value delivered by these disclosure documents. The industry appears to agree that in many cases disclosure alone (while compliant) does not deliver a position where the client is fully informed and understands the advice and products provided.

Skills and education development are core building blocks of a strong Australian economy both now and into the future. The investment in the development of deeper skills and education will pay dividends for society and the broader economy for many decades. Coupled with the focus on skills and education is the need to ensure better outcomes in terms of financial literacy for the broader community. Increasingly, all members of the community are exposed to financial information that they are expected to understand and navigate their way through on a day-to-day basis. A lack of awareness of many in the community of their superannuation and retirement savings strategies, excessively high levels of debt and gearing among those who should not be exposed to such high-risk strategies and the increasing prevalence of mixed and variable quality information through the internet, are examples of this pressing need.

Embedding appropriate levels of basic financial literacy in the national school's curriculum is seen by the Institute as another important ingredient in helping to bolster the capacity of future generations of Australians to be properly equipped with the right information to assist with making personal, employment and business decisions over time. Chronic under-investment of resources in this vitally important area could ultimately have a damaging effect on the capacity of future generations being able to appropriately navigate their way through the complex business environment they will be increasingly exposed to as they move into the workforce.

The Government's Moneysmart week, an initiative developed by the members of the Government's Financial Literacy Board and the work being done by ASIC and its Financial Literacy strategy are key to long term success of improving Australians financial literacy. These initiatives are crucial to making generational change to Australians' financial understanding, engagement and developing greater responsibility.

Recommendation 16: The Inquiry should consider the current financial literacy initiatives and framework and ensure basic financial literacy is embedded into the national school's curriculum and encourage greater financial literacy in the wider community.

4.2 Enhancing Australia's international competitiveness

Fostering a stronger innovation culture across Australian and New Zealand businesses, along with improvements in productivity outcomes will be key drivers of Australia's ability to become an even more competitive market economy in the future. Regulatory settings must therefore support those objectives, not work against them.

In regards to the terms of reference relating to taxation, we make the following observations which should be considered during the Tax Policy White Paper process:

Recommendation 17: The corporate tax rate be reduced to a rate of 25% in the medium term (in line with the recommendation in the Henry Review). We acknowledge that reducing the corporate tax rate will be difficult to implement given the current fiscal circumstances, however, a reduction will strengthen Australia's capacity to attract capital investment in the global market place. The increase in capital investment will encourage private sector investment and growth, which has flow-on benefits for productivity improvements and job creation.

The Institute also supports these recommendations from the November 2009 Johnson Report, *Australia as Financial Centre: Building on our Strengths* and urges the Government to continue with these recommendations.

- The introduction of an investment manager regime (IMR) that will, in effect, ensure that no additional tax will arise as a result of an international investment fund using an Australian funds manager. This is designed to overcome concerns that the use of a local fund manager can result in income and profits being ‘sourced’ in Australia and subject to tax that would not otherwise apply. The Government has agreed with the recommendations, but the current IMR has only partially been implemented, is uncompetitive in that it has conditions which are inconsistent with other jurisdictions, and is overly complex. We recommend that the IMR be re-examined.

- Reform to the Offshore Banking Unit (OBU) regime to give full effect to the Government’s policy intentions for OBUs. In this regard, we support the Government’s recent decision to defer the start date for changes to the OBU regime for more targeted integrity rules so that the changes recommended by the Johnson Report can be fully considered and implemented in one complete package. Implementing the reform to the OBU regime will encourage international investment, which should facilitate Australia’s development as a regional financial centre.

- The types of allowable Collective Investment Vehicles should be broadened if Australia is to develop into an international financial services centre. Many foreign investors are not familiar with trust structures and prefer to invest in alternative investment vehicles e.g. a Luxembourg SICAV, which is a corporate entity. Providing Australian based fund managers the flexibility to service non-resident clients from Australia through alternative investment vehicles will allow the development of products which suit particular overseas jurisdictions and encourage foreign investment into Australia. Accordingly, the Government should release the Board of Taxation’s report on its review of the tax arrangements applying to Collective Investment Vehicles, together with the Government’s response, for consideration by stakeholders and inform the Tax Policy White Paper.

- Remove remaining withholding tax obligations on interest paid on foreign-raised funding by Australian banks; on interest paid to foreign banks by Australian branches; and on financial institutions’ related party borrowing. The exemption should improve access to offshore retail deposits and broaden the source of funds, thereby strengthening the overall financial resources of the economy. Reductions in interest withholding tax are consistent with international tax trends and the banking funding exemptions being negotiated in Australia’s double tax treaties.

- Ensure Islamic finance products have parity of tax treatment with conventional products. According to commentators, the Islamic financial sector has grown from virtually nothing to over $1.6 trillion in assets over the last 30 years. As Islamic banks grow larger, they are looking for new more diverse places to invest their money other than the Middle East. Accordingly, the Government should ensure that the tax laws do not inhibit the expansion of Islamic finance, banking and insurance products. The Board of Taxation’s report on their review of the Australian’s tax laws to ensure that they do not inhibit the expansion of Islamic finance, banking and insurance products should be released, together with the Government’s response, for stakeholder consideration and inform the Tax Policy White Paper.

- Remove State taxes and levies on insurance. Differing stamp duty requirements in each State create administrative complexities and lead to inconsistent treatment across States. Removing State taxes on insurance will help reduce business costs and increase economic efficiency and growth.

4.3 Fiscal sustainability

Australia is one of only a handful of nations that currently enjoys a AAA credit rating. However pressures are emerging to the fiscal position, through narrowing tax bases and increased expenditure. Policy outcomes which deal with these pressures are needed.

<u>Retirement age</u>

At the time the aged pension was introduced, the average life expectancies were below the age of access. However life expectancy has increased significantly since then and now well exceeds it. In the future we can reasonably expect life expectancy to increase further. Currently, 80% of people over the age of 65 are reliant on some form of aged pension. This is not sustainable in the long term. The aged pension was originally introduced as an absolute safety net for those who outlived their life expectancy and had no other means of support. Community expectations around the aged pension have changed to one that is now more aligned with automatic entitlement.

Recommendation 18: A review of the aged pension including the access age. Additionally, consideration will be needed around the practicalities of longer workforce participation which may include providing incentives to employers to engage older workers and for older workers to remain in the workforce.

Superannuation benefits

Recommendation 19: Whilst we don't support small scale, frequent changes to the superannuation system, we recommend the Inquiry consider a holistic review with a long term focus as this is important for the system's long term future. Part of this review should include superannuation benefit options, including income streams versus lump sums; incentives versus compulsion and the various taxation implications. The interaction of superannuation benefits with mortgages on family homes also needs to be considered as the two are linked for many individuals. This might include whether retirees should be allowed to take lump sums to pay off their mortgage. Further, we encourage the development of annuity products, which may balance the needs of consumers with the sustainability of system.

Increasing financial independence

Retirees now have to take a greater responsibility for a significant amount of funds on retirement, more than they ever have before and they need to make it last for the remainder of their life. If they can be reasonably supported to manage their finances through improved engagement in retirement planning and general financial management, savings can be made through other government benefits. Heavy reliance by Australians on the aged pension is not fiscally sustainable, with life expectancies increasing and an ageing demographic.

Recommendation 20: The Inquiry needs to consider ways to improve an individual's financial independence. The Inquiry should assist in developing a clear policy for next 30 – 40 years in respect of the retirement incomes system. The policy will need to be long term in nature, beyond the term of current government. It will need to determine the appropriate balance between the three pillars of superannuation (compulsory, voluntary, aged pension) for long term fiscal sustainability of the system by providing the right incentives and disincentives where needed. Further, we note that research performed by the Centre for Social Impact in 2012 noted that 17.7% population were excluded from access to finance.

Recommendation 21: The Inquiry to look at policy recommendations to encourage greater financial inclusion. The needs of vulnerable and disadvantaged groups need to be considered as part of greater financial inclusion. Key focus areas include ways to re-address the gender balance associated with superannuation; helping young people entering the workforce manage their higher education debt and improving access to finance for small businesses.

4.4 Greater stability of the financial markets

Regulation and supervision of the financial markets needs to be proactive in identifying and preparing for the next big shockwaves to the global economy, wherever it might come from, rather than looking to provide a retrospective fix. Aspects for further consideration include the value of integrated reporting and enhancing the communication of a broad range of risks.

International regulation and alignment

The Inquiry should also look at the impact within Australia of extra-territorial legislation, particularly from the EU and USA, such as Dodd-Frank and Foreign Account Tax Compliance Act (FATCA). This raises questions around how large organisations operate cross border and manage conflicts between the domestic and foreign legislation. The Inquiry also needs to consider the impact for other jurisdictions of any regulatory reform made in Australia. In particular, New Zealand, due to its close proximity to Australia and significant overlap of key financial institutions, is particularly susceptible to systemic risk arising in Australia.

The long-term Closer Economic Relations free trade agreement between the Australian and New Zealand governments should remain a priority. Over the past three decades, much progress has been made in boosting alignment and symmetry between financial markets, competition and tax policy, and broader regulatory settings impacting on businesses operating across the two jurisdictions, but much more can be done. Every effort should be directed towards ensuring that business activities conducted across the two jurisdictions are as seamless as possible.

Systemic risk

The financial crisis raised ongoing concerns over whether markets can alert investors to systemic risk. Regulation and supervision of the financial markets needs to be proactive in identifying and preparing for the next big shockwaves to the global economy, wherever it might come from, rather than looking to provide a retrospective fix. While the Institute recognises the importance of the existing financial reporting framework, it has its limitations because it is based on historical information and does not provide any deep insight into organisational strategy, nor does it provide sufficient information for investors to make decisions on its medium and longer-term prospects. Existing reporting frameworks do not provide the type of non-financial information that may be material to an organisation's performance. Investors need more complete, forward looking and integrated information to better understand their exposure to a broader range of risks.

High quality business reporting and disclosure are needed to better reflect the uncertainties facing companies. An integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects lead to the creation of value over the short, medium and long term. Integrated reporting seeks to provide a more complete picture of an organisation's performance in areas beyond financial metrics. The International Integrated Reporting Council (IIRC) is a global multi-stakeholder initiative which provides companies with a structure to highlight relevant and forward-looking information.

The International Integrated Reporting Framework was released in December 2013 and is intended to improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital. For investors, Integrated Reporting enhances the disclosure of key risks and opportunities as management views them which enables investors to assess the short, medium and long term impact. Further, many Australian investors are members of the United Nations Principles of Responsible Investment (UNPRI). Signatories to the UNPRI note their fiduciary responsibilities as:

> *As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.*

The identification of potential future shockwaves will involve a wide range of risks. For example, a 2013 report by ACCA (the Association of Chartered Certified Accountants) and Carbon Tracker, (*Carbon avoidance? Accounting for the emissions hidden in reserves)* specifically noted the failings of the current reporting standards to flag the systemic risks of climate change in the fossil fuels sector. There is growing recognition of a potential carbon bubble, stranded assets arising from unburnable fossil fuel reserves. However, the report noted insufficient information disclosed on the carbon emissions of current proven coal, oil and gas reserves to enable investors and regulators to monitor the levels of systemic risk. In the past month the topic has been raised in a report by the

Environmental Audit Committee of the UK Parliament as well as suggestions the Norwegian Sovereign Wealth Fund is reviewing its investments in fossil fuel companies.

Recommendation 22: We recommend the Inquiry review the existing risk disclosures, particularly for financial institutions and consider how these can be enhanced to better communicate the risk profile of a broad range of risks. For example, financial institutions could disclose their loan and asset portfolios according to industry. This would identify potential exposure to a particular industry's risks, such as the carbon bubble in the fossil fuels sector noted above. Consideration should also be given to disclosures of the carbon emissions in reserves to help inform investors of that specific potential risk. However, we note disclosure is not the only means of providing protection and that any review of disclosure needs to be holistic and not just add to existing requirements.

4.5 Boosting productivity and cutting red tape

A policy environment that both enables and supports productivity growth must be supplemented by a comprehensive and ongoing program of wide-reaching reform. Any attempts to reduce red tape should be done in a holistic manner without jeopardising productivity, innovation and investment, but at the same time acting in the interest of all Australians. Technological solutions (i.e. an 'e-government' approach) should be sought to reduce regulatory burdens that cannot be eliminated. Initiatives such as the government's Cutting Red Tape website is an approach that is seeking to reduce regulatory burden and the Institute looks forward to the outcomes of this initiative. Further it is important that there is consistency between regulations to ensure commercial decisions are made for commercial reasons and not for accounting, tax or legal reasons.

Alternative funding options for small business

We encourage the Inquiry to consider ways to develop and encourage alternative funding arrangements which might be more attractive to small business owners. We also note that research indicates that approximately 80% of a business' value is now in intangible assets, as opposed to 80% in physical assets 40 years ago. The value of a business is therefore in ideas and technology, rather than property and equipment. If Australia is to develop its competitive advantage further, funding the ideas and potential of small businesses will need to be part of this development.

Potential options the Inquiry could explore include equity crowd funding, peer to peer lending and pooling small businesses to tap into public corporate bond markets, either directly or through agency.

Recommendation 23: We recommend the Inquiry review the barriers to alternative funding arrangements and consider whether they can be removed.

Recommendation 24: The Inquiry to look at micro-finance operations and the regulations and associated costs for their loans. The cost of making a small loan should represent an appropriate proportion of the loan value rather than being the same as that of a large loan from a major bank.

Cumulative impact of regulation

Australia has been subject to a large number of reviews and inquiries recently. We consider an appropriate balance is needed between providing the safety and soundness required by consumers and business with the level of regulation. Higher regulation could result in higher costs for consumers and business and as a consequence lower financial returns and less efficiency. The financial system is closely inter-related and linked, which means a change in regulation in one place could have unintended consequences and potentially unnecessary duplication in a number of other areas.

The Institute acknowledges that, in isolation, many individual components of regulation may have a strong underlying foundation in policy terms, but taking time to reflect on the macro-level implications of certain obligations, along with a consideration of how those regulatory impacts interact with other regulations is not always undertaken as part of the process of developing and embedding new regulation.

Recommendation 25: The Inquiry should take a broad perspective in determining the impacts of proposed reform and consider the burden imposed on all organisations, individuals and society as a whole. Many of the challenges of the future do not have simple solutions and the impacts of reform can affect different groups in various ways. Therefore, the review should be done in a holistic manner without jeopardising productivity, innovation and investment, but at the same time acting in the interest of all Australians.

<u>Unclaimed money</u>

In December 2012, Commonwealth laws that govern unclaimed money were amended by the *Treasury Legislation Amendment (Unclaimed Money and Other Measures) Act 2012* .This means that some money may be identified as unclaimed after a period of 3 years (previously 7 years). ASIC makes recommendations such as making a five cent deposit or withdrawal every two-three years to prevent loss of the account. This creates an unnecessary burden on both the financial institution and the consumer. Many consumers retain savings accounts for a 'rainy day' or for their children, which for tax reasons they may wish not to withdraw from. We consider three years to be too short a period and that five years may be more appropriate.

Recommendation 26: We encourage amendments to treat money as 'not unclaimed' in accounts held at financial institutions where the account holder is active on other accounts, regularly views the account through online banking or has the interest paid into another account which is active. Further, it should be possible to avoid the account being classed as unclaimed if the account holder contacts the financial institution, when notified that there have not been recent transactions on the account, to confirm ownership and contact details. It should not be necessary for there to be a transaction as well in these circumstances.

4.6 Additional investment opportunities

As the pool of superannuation funds continues to grow in the future, alternative investment opportunities need to be available.

<u>Infrastructure</u>

The long term nature of superannuation means it is a good fit for infrastructure investment. Superannuation funds are generally more interested in established infrastructure investment, as this has a proven record and is therefore less risky than new infrastructure. However, 31% of the total superannuation assets are held in SMSFs who cannot separately access infrastructure investment. Mechanisms could be put in place to enable this to happen, for example, the Inquiry could explore the possibility of infrastructure bonds.

<u>Corporate bond market</u>

We encourage the further development of the corporate bond market. Many large companies are using this to raise funds instead of equity. However, we note that the development of the retail component of the market is being impacted by the government's financial claims scheme. Further, we note development of the corporate bond market would assist in providing alternative investment opportunities for superannuation funds outside of the equities market.

However, we also recommend increasing awareness of the different types of instruments available through the market. Whilst 'vanilla' instruments can help increase competition and stability, the risks associated with highly complex hybrids such as subordinated debt notes may not be fully understood by the retail investor.

Savings
On the savings side, we recommend further analysis be undertaken across a range of savings products to evaluate what options exist for a more uniform approach to the taxation of savings. Income tax arrangements for savings and returns on capital investment vary considerably and these differences affect how households allocate their savings between different assets or savings vehicles.

International investment
There is an increasing proportion of Australia's retirement savings pool likely to be invested in regional capital markets. This, coupled with the country's much greater economic integration with Asia, increases the risk of contagion to Australia should there be adverse developments in regional capital markets. Consequently, in considering the integration of international financial regulation, the Institute recommends the Inquiry consider how the integrity of regional capital markets might be enhanced potentially through:

- the avoidance of regulatory arbitrage, and
- through strengthening inter-jurisdictional monitoring and enforcement in areas such as independent audit oversight.

There is a need to focus on regulatory convergence to create a level playing field globally for multi-national organisations. We encourage the committee members to avoid Australian specific reforms and instead to seek alignment with G-20 and Financial Stability Board recommendations.

4.7 Longevity of outcomes
In the last few years, Australia has been subject to a large number of wide ranging reviews and inquiries, for example the Australian Financial Centre Forum's report on Australia as a Financial Centre (the Johnson Report). A number of recommendations from these reviews have not been delivered or remain un-enacted. For these reviews to receive the appropriate attention and focus from the various stakeholders, it is critical that they are seen to deliver results and not just become another report on the shelf.

Recommendation 27: The Inquiry should be staffed for a couple of years following the delivery of the final report to enable recommendations to be followed through and delivered upon.

Appendix A

About the Institute

The Institute represents accounting and business professionals in Australia and around the globe. Members strive to uphold financial integrity through a commitment to ethics and acting in the public interest.

We focus on educating candidates through the Chartered Accountants Program and engage in advocacy and thought leadership underpinned by our members' knowledge and experience. We influence a range of policy areas impacting the Australian economy and domestic and international capital markets.

A watershed member vote in 2013 set the course for the Institute to amalgamate with the New Zealand Institute of Chartered Accountants(subject to obtaining formal government approvals and effecting amendments to constituent documents), with the vision of becoming the trusted leaders in business and finance.

The proposed new institute – Chartered Accountants Australia and New Zealand – is expected to have more than 90,000 members in total with 17,000-plus candidates, giving us greater scale and influence on the world stage.

We are on the Board of the International Federation of Accountants, and are connected globally through the 800,000-strong GAA and Chartered Accountants Worldwide which brings together leading Institutes in Australia, England and Wales, Ireland, New Zealand, Scotland and South Africa to support and promote over 320,000 Chartered Accountants in more than 180 countries.
charteredaccountants.com.au