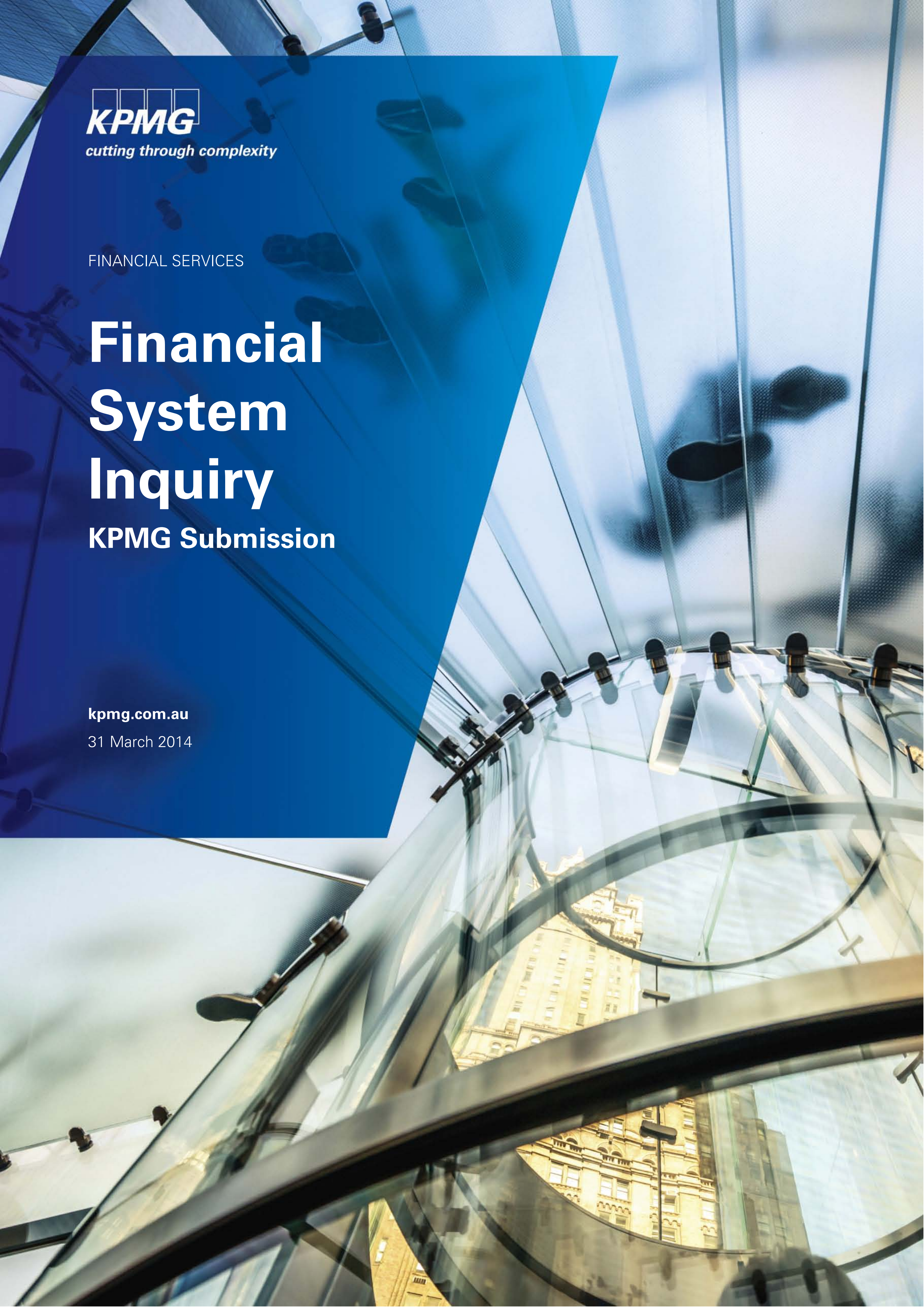

KPMG
cutting through complexity

FINANCIAL SERVICES

Financial System Inquiry

KPMG Submission

kpmg.com.au

31 March 2014

10 Shelley Street
Sydney NSW 2000

PO Box H67
Australia Square 1213
Australia

ABN: 51 194 660 183

Telephone: +61 2 9335 7000
Facsimile: +61 2 9335 7001
DX: 1056 Sydney
www.kpmg.com.au

Mr David Murray AO
Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

Dear Mr Murray,

Financial System Inquiry

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

We have the privilege of advising the full spectrum of organisations in the financial services industry, including banking (retail, wholesale, investment banking, and mutuals), wealth management, insurance and superannuation. Through this broad industry engagement, we have perspectives on a range of current and emerging industry issues and trends.

We strive to contribute in a meaningful way to the debate that is shaping the future of the industries we serve. To this end, we welcome the opportunity to respond to the Financial System Inquiry (the Inquiry), which is seeking to lay out a blueprint for the financial system over the next decade.

We believe the Inquiry provides a unique opportunity to identify major hurdles to growth and innovation and respond to changing domestic and international dynamics. We would like to take this opportunity to offer a set of key observations and recommendations to the Inquiry.

The current regulatory framework is broadly sound and has served Australia well to date – in notable contrast to the situation in much of Europe and the US throughout the global financial crisis (GFC). Previous financial system inquiries, including the "Campbell Report" in 1981 and the "Wallis Report" created the regulatory structure that enabled us to weather the GFC relatively well.

However, we do see a need for modifications to the regulatory framework to ensure an appropriate balance between financial system stability, growth and efficiency, and to avoid excessive compliance burdens for financial institutions. Opportunities exist for improved coordination between regulators and in the design and implementation of new regulation, such as ensuring that rigorous cost/benefit analyses have been performed.

We encourage efforts to promote greater levels of regional integration of our financial system with Asia, supporting regulatory harmonisation and use of our strong relationships and mutual interests with our Asian neighbours to influence the global regulatory agenda.

There is also merit in exploring alternatives for a new funding and investment model that better serves the needs of borrowers (households, business and governments) and investors, that also supports filling critical infrastructure funding shortfalls.

The substantial development of our compulsory system of superannuation since the "Wallis Report" in 1996 also calls for a refinement of the superannuation system in order to encourage the appropriate management of longevity risk and product innovation.

We are at an inflexion point in financial services, driven by the increased adoption of new technology, such as mobile banking and innovation in payments, and changing consumer preferences. We expect this to fundamentally change the distribution and consumption of financial products and services.

Finally, this technological innovation also brings rise to potential vulnerabilities, such as cyber-crime, that need be to better understood and addressed to protect consumers, businesses, financial institutions and the financial system itself.

KPMG would be pleased to provide further information to the Inquiry Panel that would assist you with your deliberations. Should you require this information or have any questions please do not hesitate to 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

Ian Pollari
Partner, Financial Services

Contents

Executive Summary

KPMG welcomes the Financial System Inquiry (the Inquiry) as an opportunity to examine and improve a broadly sound financial system and regulatory architecture. As international and domestic markets evolve to respond to changes in consumer behaviour, patterns of trade and investment, funding, ageing demographics and new technology, the Australian financial system and regulatory framework should adapt to ensure both a stable and efficient market, as well as an environment that supports innovation and economic growth. Below is a summary of our observations and recommendations.

Improving our regulatory framework to better balance stability, growth and efficiency

Our starting premise is that our financial system and regulatory architecture is broadly sound. Therefore, the focus of the Inquiry should be on improvements to, and not wholesale changes of, the existing system. However, there are a number of regulatory and prudential issues that are within the scope of the Inquiry and that offer an opportunity to address a range of matters. In particular, we recommend:

- strengthening the requirements for costing regulatory proposals, with more rigour around the assessment of compliance costs and efficiency costs, and considering a broader range of factors, including economic growth, productivity, innovation, trade and investment;
- requiring all regulations to be subject to comprehensive, industry-wide review at regular intervals. Importantly, this would allow for an assessment to be made of the cumulative impact of regulation (cost/benefit) across all regulatory agencies;
- encouraging the regulatory and competition agencies to work together to develop a consistent framework for defining, measuring and promoting financial system efficiency outcomes;
- adopting a more differentiated, risk-based approach to prudential regulation, with a lower level of regulatory burden being placed on smaller ADIs, insurers and superannuation funds, while still ensuring acceptable prudential soundness; and
- strengthening regulator direction and performance through formalising key performance indicators and external performance assessment.

Promoting greater regional integration and regulatory harmonisation with Asia

The growing integration of our economy and financial markets with Asia presents significant opportunities for Australia. To support this development, greater attention needs to be paid to the scope for, and costs and benefits of, closer integration and harmonisation of regulation between Australia and other jurisdictions, especially within the Asia-Pacific region.

KPMG sees a need for Australia, in conjunction with other countries in the Asia-Pacific region, to seek greater influence on international standard setting processes. To this end, Australia could work more closely with other jurisdictions within Asia to promote greater regional influence on global regulatory-setting bodies, for example, by encouraging a periodic regional rotation of chairing of the Financial Stability Board (FSB).

Enhancing diversification of funding and supporting superannuation investment in long-term asset classes

It became clear throughout the GFC that Australia's financial system utilised short-term wholesale funding, which could not necessarily be relied upon in a crisis situation. There are a range of options that could be explored to encourage "stickier" and longer term funding by and for the Australian financial system.

One recommended measure is to facilitate the provision of long-term funding through the superannuation system by exploring lock-in products, allowing an investor the ability to choose to forego the ability to "switch" (either investment options or funds) for a period, and/or agree to a longer notice period for any "switch". This type of product should facilitate increased asset allocation to infrastructure, venture capital/private equity and other types of longer term, less liquid investment classes.

In addition, minor changes to tax settings may have significant effects on capital flows, opening up greater access for offshore funding and domestic opportunities. Our recommended changes to tax policy include:

- creating access to foreign and domestic investment for local infrastructure by simplifying tax settings;
- facilitating access to the offshore retail funding market through recalibrating tax and regulatory settings – particularly through removing interest withholding tax;
- reviewing tax settings on long-term and inflation-linked bonds with a view to rebalancing treatment of long-term debt versus equity; and
- enabling access to the wholesale Islamic financing hub through minor tax amendments.

Re-purposing the superannuation system to better address longevity risk

A key development in the Australian financial system since the 1997 review is the maturity of the superannuation system. As the first "baby boomers" start retiring, the superannuation system is transitioning from an investment-based system to a pension-based system.

The system has been highly successful in its role of pooling investment funds. But this success may create a challenge in moving to the pension phase, when the superannuation system will increasingly be looked to by retirees as a means of protecting against future expenditure needs, including protecting against increases in longevity.

There is an opportunity to create incentives to manage longevity risk, and encourage the product development and annuitisation required in a transition to a pension-based system. This is urgent given the looming demographic position of retirement of the "baby-boomers". Our recommendations include:

- supporting the management of longevity risk through appropriate insurance options;
- improving incentives to self manage longevity risk, such as provision of a relative tax advantage; and
- encouraging product innovation.

Enabling the take-up of digital and new payments services to boost productivity and addressing emerging technology risks

With digitally enabled changes in the financial services industry set to accelerate over the next decade, KPMG believes that a flexible regulatory framework that is responsive to changing consumer preferences, allows for further product and service innovation, but provides for a safe and sound financial system will be critical.

Australia has one of the most advanced payments systems globally and, on a range of measures, compares favourably with many international jurisdictions. As such, KPMG contends that the current regulatory structure of the payments industry in Australia works well, and is not in need of significant change.

However, with the emergence of new technologies and non-traditional entrants into financial services likely to increase substantially in the future, considerations should be given to an appropriate level of regulatory oversight of new entrants into the payments industry.

KPMG considers setting a clear high-level policy framework, developed in conjunction with the Reserve Bank of Australia (RBA) and industry participants (existing and new participants) as being a sensible mechanism to consider the most appropriate policy and regulatory settings, ensuring the right balance of stability, efficiency and competition objectives is achieved.

The evolution of the financial system is inevitable and traditional financial systems are increasingly interconnected with electronic global networks that are constantly under attack. To this end, cyber security has the potential to be a systemic risk to the financial system.

In order to respond to these emerging threats, empowering regulators to oversee cyber security standards adoption for corporations that deal with or process large numbers of consumer generated financial transactions is recommended. Finally, assessing the likelihood and response capability of an industry-wide cyber attack with a view to creating an industry-wide response should be endorsed and prioritised.

Regulatory Framework

Improving our regulatory framework to better balance stability, growth and efficiency

The Inquiry is a welcome opportunity to consider how effective Australia's regulatory framework is in terms of responding to a changing domestic and international landscape (and addressing risks that will inevitably arise), as well as enabling the financial system to support future economic growth. To this end, it is critical that regulatory reforms are designed and implemented in a way that balances the need to ensure depositors, policyholders and investors are protected and that desired regulatory outcomes can be achieved in a cost-efficient manner, without unduly compromising growth and financial efficiency.

KPMG believes that, in most respects, Australia's financial regulatory architecture is sound and has served Australia well since it was established in 1998. In particular the "rules of the game" have generally been well explained and administered, and have been capable of adapting to the changing circumstances of the Australian economy and global economic developments. The GFC did not cause a measurable loss of depositor or investor confidence with key financial entities. The ability of institutions and markets to continue functioning was not materially impeded, although significant policy decisions were and did have to be taken at short notice. The regulatory architecture was capable of advising upon and implementing these decisions effectively. This is not to say that retail investors did not incur financial losses.

Our starting premise is that we consider our financial system and regulatory architecture to be broadly sound. Therefore, the focus of the Inquiry should be on improvements to, and not wholesale changes of, the existing regulatory system. However, there are a number of regulatory and prudential issues that are within the scope of the Inquiry and that offer an opportunity to address a range of matters. We comment on these below.

More rigorous cost/benefit analysis of regulatory proposals

A critical aspect of regulatory architecture is the process for regulation making. It is essential that there are structures to promote more effective cost/benefit analysis of regulatory proposals, anchored to transparent and sensibly balanced regulatory objectives.

Although Australia has a framework for assessing the costs and benefits of proposed regulations through the Regulatory Impact Statement (RIS) process and the Office of Best Practice Regulation (OBPR), there is considerable scope for improvement. In particular, we recommend a need to:

- strengthen the requirements for costing regulatory proposals, with more rigour around the assessment of compliance costs and efficiency costs, and consider a broader range of factors, including lost economic growth, productivity, innovation, trade and investment (while acknowledging that impacted parties have an important information role to play in this regard);
- strengthen the assessment of risks associated with regulatory proposals, including potential risks of adverse efficiency outcomes, moral hazard risk and dilution of market discipline;
- give greater emphasis to the assessment of alternative options for meeting desired regulatory outcomes;
- bring forward the assessment of alternative regulatory options in the policy formulation process;
- bring greater whole-of-sector consultation (as mentioned further below) to regulatory proposals so there is meaningful contestability of ideas and sharper accountability in the regulation-making process; and
- require all regulations to be subject to comprehensive, industry-wide review at regular intervals (for example, possibly every five years). Importantly, this would allow for an assessment to be made of the cumulative impact of regulation (cost/benefit) across all regulatory agencies.

Improved whole-of-sector consultation across industries

Another important element of regulatory architecture is the consultation between regulators and industry. Currently, there does not appear to be an effective mechanism by which whole-of-sector consultation between regulators, Treasury and industry can occur on a regular basis. Consultation tends to be issue-specific via consultation papers issued by individual regulators, rather than on a whole-of-sector basis.

Given the inter-linkages between the different spheres of regulations within the sector, and the increasing inter-connectedness of financial institutions, KPMG suggests that consideration be given to facilitating more whole-of-sector consultation. This could be achieved by regular (for example, annual or six monthly) consultation at a strategic level between the Council of Financial Regulators (the Council) and the joint heads of the industry peak bodies. This may be especially useful as a forum for exchanging views on whole-of-sector issues where coordination between regulators is necessary in order to minimise the risks of duplication, to synchronise consultation on related issues and to consider progress in meeting financial system stability and efficiency outcomes.

Greater clarity of efficiency objectives

Although the APRA Act and some other legislation refer to financial system efficiency, KPMG sees a need for greater clarity as to what is meant by this term. There is relatively little published material by the Australian Prudential Regulation Authority (APRA), the RBA, the Australian Securities and Investments Commission (ASIC), AUSTRAC or the Australian Taxation Office (ATO) on how they interpret efficiency in a financial system context, the means by which policy instruments could contribute to financial system efficiency outcomes, and the ways the impact of proposed regulation on efficiency can be measured and assessed.

Consideration should be given to requiring the agencies to work within the Council and with other relevant agencies (such as the Australian Competition and Consumer Commission [ACCC], the Productivity Commission and the OBPR) to develop a framework for defining, measuring and promoting financial system efficiency outcomes. We suggest that the Council and its member agencies publish information regularly to identify progress in meeting financial system efficiency objectives, as well as the other statutory objectives with which they are charged. In this context, we see a need for greater information from APRA, ASIC, AUSTRAC and the ATO in their assessment of the efficiency implications of their respective regulatory proposals and requirements, including (as appropriate) compliance costs, potential impacts on financial product pricing, impacts on financial innovation, allocation of funding across the economy, and impacts on business organisation.

Risk based approach to prudential regulation

The current approach to prudential regulation generally involves a relatively uniform application of regulation to each category of regulated entity. Relatively little allowance is made for the scope, scale and complexity of business in the design of regulation. As a result, smaller ADIs, insurers and superannuation funds have increasingly been faced with regulatory requirements that are, arguably, disproportionate to the scope and scale of their business. This has resulted in very substantial compliance and capital burdens for these entities.

KPMG considers that the intensity of regulation needs to better match the intensity of the risk. Therefore, we recommend that consideration be given to the costs/benefits of APRA adopting a more risk-based approach to prudential regulation, with a lower level of regulatory burden being placed on small ADIs, insurers and superannuation funds, while still ensuring that acceptable prudential soundness standards are complied with.

An example is the current, approach taken by APRA to the advanced accreditation of banks under Basel capital rules. We believe it may be appropriate to allow smaller institutions to adopt, at least partially, advanced capital models for their mortgage portfolios when they can demonstrate sufficiently robust data and modelling, without having to apply advanced models across their lending portfolios, or for operational and non-traded market risk. This is discussed later in specific reference to the mutuals sector.

Similarly, it would be desirable to explore the scope for greater differentiation in prudential regulation for small foreign banks, with a greater allowance made for the risk management frameworks established in a foreign bank's head office.

Although we raise the issue of differentiation in the context of prudential supervision, a similar argument can be applied to market conduct regulation by ASIC. In this regard, we would also suggest consideration be given to greater differentiation of regulatory requirements having regard to the scale, scope and complexity of a financial institution's operations, and the materiality of risks posed to customers and the community.

Additional improvements to prudential regulation are made further in the submission.

Regulator performance indicators and assessment

A further issue relating to regulatory architecture is the importance of regulator performance. Although the financial sector regulators are accountable to ministers and Parliament for the performance of their functions, there is scope for strengthening the arrangements. In particular, it is suggested that consideration be given to refining and formalising Key Performance Indicators (KPIs) for APRA, ACCC, ASIC, AUSTRAC, ATO and RBA in respect of their regulatory and financial stability functions. The KPIs should be primarily outcomes-based, determined by agreement between the government and the regulator. The KPIs need to be broad based enough to balance consideration of the potentially competing objectives of the regulators.

Consideration could also be given to enhancing the reporting obligations of regulators, with a view to establishing more comprehensive reporting on their performance against KPIs.

As part of this process, KPMG sees a need for greater external assessment of regulators in the performance of their functions. Our understanding is that, although government departments such as Treasury oversee the regulators, and they are overseen by Parliamentary committees, there is little in the way of specific regulator performance assessment other than via the periodic IMF Financial Sector Assessment Program. It is therefore suggested that each regulator should be assessed on a regular basis (e.g. five-yearly), drawing on foreign and domestic expertise as necessary. The performance assessments should be published as part of the transparency arrangements.

Council of Financial Regulators

The Council is an important part of the financial regulatory architecture. It provides a high-level coordination forum for most of the financial regulators and Treasury and thereby assists in achieving more cohesive whole-of-sector regulatory outcomes. Our impression is that the Council has played an important part in the successful regulation of the financial sector since its creation. However, we do see scope for some enhancements. In particular, we believe its role, transparency and accountability would be strengthened if it were given statutory recognition. At present, it is an administrative body with no statutory foundation or accountability.

We therefore suggest that the responsibilities, membership, transparency and accountability of the Council be set out in statute, including an obligation to produce an annual report setting out its activities for the year under review. In making these enhancements, it is important that the Council remains a vehicle for coordination and cooperation, and does not assume powers that appropriately rest with the relevant member agencies.

We also suggest that consideration be given to widening the Council's membership to include other financial sector regulators, such as AUSTRAC, with scope for the ACCC to participate in Council meetings to the extent that it sees relevance in doing so (for example, on issues relating to contestability and competitiveness). A widening of membership would strengthen the Council's ability to perform its role as a coordination body on a whole-of-sector basis.

Improvements to regulatory architecture

The 'Twin Peaks' model provides a system for the division of responsibility between APRA, separated from the RBA, and ASIC. The regulatory architecture has enabled APRA to focus its attention on prudential soundness issues and build a capacity appropriate to that role in a way that might not have occurred as readily under the former regulatory framework or under the regulatory architecture common in many other countries. We believe the establishment of APRA as a stand-alone, dedicated prudential regulator was a significant factor contributing to the resilience of the Australian financial system during the GFC.

It is notable that, since the crisis, some countries have reviewed their regulatory architecture with regard to the Australian Twin Peaks model, and have adopted or are proposing to adopt similar arrangements. Given the merits of the Twin Peaks model, we do not see a need for fundamental change to the regulatory architecture in Australia. However, we do think improvements can be made. These are discussed below.

Respective responsibilities of APRA and RBA

An issue that may come under consideration in this Inquiry is whether APRA should be incorporated into, or become accountable to, the RBA, in recognition of the overlap in responsibility between the central bank and prudential supervision authority. As you will be aware, the United Kingdom has adopted this model.

Although arguments can be made for prudential supervision being located within the central bank, KPMG is inclined to the view that the current model – with APRA remaining a separate authority focused on prudential supervision – is the better arrangement. Retaining APRA as a separate agency recognises that prudential supervision is a specialist area of focus and is not limited to banks or other deposit-taking entities. It draws on skills, knowledge and experience that are not always readily found in central banks, given the latter's macro-financial and monetary policy focus. It also has a set of cultural traits that are different in key respects from those of a central bank. These differences may suggest that it is better to keep the two agencies separate, given the complications that can arise in trying to combine quite disparate organisational cultures.

Moreover, there are risks in merging the prudential supervision authority into the central bank. One of these risks is that prudential supervision could become a subordinate function within the central bank, receiving less attention from senior management than monetary policy, both day-to-day and at a strategic level. This has the potential to weaken the effectiveness of supervision and to impede the ability both to be proactive and to respond quickly to events when necessary.

A further risk of incorporating prudential supervision in the central bank is the potential conflicts of interest between the central bank and the supervision authority, especially in the context of macro-prudential supervision. The central bank's primary role is to maintain price stability in the context of promoting general macro-financial stability. The prudential supervisor's task is to promote the stability of the financial system and, within that, the prudential soundness of individual financial institutions. Although these two sets of responsibilities clearly overlap and will often be complementary, there are times when they may pull in opposite directions. While these policy tensions can be managed within the central bank, we believe the most satisfactory means of doing so is by retaining prudential supervision in a separate agency with a primary focus on financial stability.

We therefore believe that keeping APRA as a separate and independent agency is the preferred option. However, we do see benefit in clarifying the respective objectives and functions of the RBA and APRA to enhance the existing arrangements. We discuss this below.

Regulatory functions and objectives

A key to effective regulation is the clear and transparent specification of regulatory functions and objectives. Although the responsibilities of the main financial sector agencies are clear in practice, there are some deficiencies in the statutory specification of responsibilities and objectives.

In the case of the RBA, the Reserve Bank Act 1959 (RBA Act) is silent on the role of the RBA in promoting the stability of the financial system, other than in reference to limited areas of its responsibilities. For example, section 10 of the RBA Act, which sets out the functions of the RBA Board, makes no reference to financial system stability. Section 10B refers to financial stability functions, but only in a relatively narrow context.

Consideration should be given to amending the RBA Act to explicitly specify the RBA's responsibility in promoting the stability of the financial system and to make this part of its statutory objectives. Consideration should also be given to the statutory powers the RBA may need to discharge its obligations in this regard.

In the case of APRA, section 8 of the Australian Prudential Regulation Authority Act 1998 (APRA Act) sets out the functions of APRA. This section states: "In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia".

We contend that the current formulation of wording in section 8 of the Act does not provide sufficient clarity of focus for the exercise of APRA's powers. The objectives listed in section 8 are not ranked, giving no sense of what the primary objectives are or should be, or how conflicts between objectives are to be resolved. Based on what we have observed, APRA's approach, in practice, is focused more on prudential soundness and financial stability, with relatively less attention given to efficiency. This is understandable, given APRA's primary mandate. However, we see a need for greater balance in this area, with more emphasis given to efficiency and related considerations than has tended to be the case to date.

In this context, we believe that the Inquiry consider tightening the wording in this section of the Act, with a view to achieving greater clarity and balance of objectives. Although APRA's primary objective should remain the promotion of financial stability, the APRA Act should ensure that financial efficiency and competition objectives are not overlooked.

With respect to macro-prudential supervision, we believe there is a need for greater clarity of policy objectives and the means by which these objectives are met. We suggest consideration be given to enacting a statutory provision in the RBA Act and APRA Act requiring APRA and RBA to publish a Memorandum of Understanding that specifies the objectives of macro-prudential supervision, the responsibilities of APRA and RBA, respectively, in meeting these objectives, and the means by which any potential conflicts or inconsistencies between micro-prudential and macro-prudential supervision objectives are to be addressed.

Prudential regulation

Recent years have seen an unprecedented wave of prudential regulation in Australia. Much of this has been driven by global initiatives, particularly those initiated by the Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS) and International Association of Insurance Supervisors (IAIS). However, a substantial proportion of regulation has also arisen from APRA's domestic policy agenda.

In most respects, the strengthening of prudential regulation is likely to assist in promoting a more resilient financial system and enhance the prudent management of risks by financial institutions. Indeed, KPMG believes APRA has been very effective in targeting a number of areas which will assist in further strengthening the Australian financial system. Good examples of this have been APRA's initiatives in relation to the strengthening of ADI and insurer capital requirements, strengthening and harmonising governance and risk management requirements, and focusing greater attention on conglomerate risk. APRA, together with the other Council members, has also made important progress in improving the capacity to resolve financial institution distress.

However, the strengthening of prudential regulation also entails very considerable compliance costs and potential efficiency costs. As noted earlier in this submission, we believe there is scope for improving the cost/benefit analysis of regulatory proposals and for a greater focus on efficiency issues in the pursuit of financial stability outcomes. Going forward, we think all new prudential requirements would benefit from greater scrutiny in these respects to ensure that financial stability outcomes are not achieved at excessive compliance and efficiency cost.

Once the new regulatory arrangements have been bedded down, it would be desirable for an assessment to be made of the costs/benefits of the regulations, with a view to addressing any areas where regulatory initiatives are found to be excessive or to produce costs disproportionate to the benefits. These impacts should also be part of the periodic review of regulation referred to above.

Possible examples where regulation in Australia may be excessive relative to international benchmarks include:

- insurance capital requirements;
- prudential requirements for small ADIs and insurers;
- prudential requirements for superannuation funds; and
- areas where APRA has adopted 'super equivalence' to global prudential standards, or implementation timelines.

Aside from this general observation, KPMG has a number of specific comments on matters relating to prudential regulation.

Capital requirements for insurers

The review of the capital framework by APRA for life and general insurer in 2013 (LAGIC) was accompanied by a decision to set a single, minimum prudential requirement (referred to as the Prescribed Capital Requirement (PCR)) at a level equivalent to that of a rating agency capitalisation level of BBB, which equates broadly to a 1 in 200 probability of failure or a value at risk (VaR) measure of 99.5% over a one year time horizon. This level of capital was determined by APRA based on extensive analysis of comparable regimes and with due regard to banking requirements, noting the specificities of insurance vis-a-vis banking that justified the reason for setting a lower capital standard. This study was undertaken in the late 1990s.

Australian life insurers are required at all times to maintain a buffer above the PCR level; the size of the buffer is determined by the board of directors but is closely monitored by APRA via the Internal Capital Adequacy Assessment Process (ICAAP) process. In contrast, Europe's new Solvency II capital standard contains two thresholds, the PCR and the Minimum Capital Requirement (MCR). Insurers are required to have capital in excess of the MCR at all times, and the PCR is set at the 99.5% VaR over a one-year horizon.

APRA's capital requirements for insurers are therefore significantly higher than those used by other jurisdictions. In turn, this results in a higher cost of capital requirement for Australian insurers and can place local firms at a competitive disadvantage internationally. It may also disadvantage policyholders to the extent that it increases the price of insurance cover and/or reduces the range of insurance products offered by insurers.

A review of the suitability of existing regulatory requirements for insurers would be timely, especially given that the IAIS is currently undertaking a project to establish a basic capital requirement (BCR) for global systemically important insurers (G-SIIs) and will use the BCR as the basis for development of a new international capital standard (ICS) for insurers.

Issues relating to smaller ADIs and mutuals (credit unions and building societies)

Within the context of prudential supervision, there are several issues specifically relating to smaller ADIs and the mutuals (credit unions and building societies) that warrant consideration, with a view to enhancing the resilience and competitiveness of the industry. Specific issues include the following:

- *Risk weightings under the Basel capital framework.* Under the current Basel capital arrangements applied by APRA, small ADIs, including mutuals, are disadvantaged by not being able to apply the lower risk weights on certain asset categories that the large ADIs with approved internal models can apply. This is especially significant in regard to residential lending, where small ADIs are placed at a competitive disadvantage relative to large ADIs. KPMG suggests that this issue be assessed, with a view to exploring the scope for a concessional risk weight being available for low-risk lending (such as residential lending), similar in nature to that available under an internal model framework, provided that an ADI satisfies specified requirements in relation to their risk management policies and practices (for example, as regards conservative lending criteria, loan review and portfolio diversification).
- *Bank licensing.* Under current arrangements, APRA requires an entity to have a minimum level of capital of $50 million in order to be licensed as a bank. This places small ADIs, such as mutuals, at a disadvantage, given that they generally have a much lower level of capital than $50 million, yet typically have a high capital ratio to reflect the lower level of their portfolio diversification and potential access to additional regulatory capital. We suggest that consideration be given to lowering the minimum absolute capital level for bank licensing, and instead place emphasis on an ADI having a minimum risk-weighted capital ratio and leverage ratio. This would preserve the integrity of the regulatory framework, while allowing small ADIs to be licensed as banks where they meet qualitative requirements and appropriate minimum capital and leverage ratio requirements.
- *Recognition of debt for capital purposes.* Currently, APRA does not allow debt instruments to be recognised for capital purposes unless the debt instrument can be converted to equity or written off. This creates a difficulty for mutuals, given they are unable to convert a debt instrument to equity under their mutual structure. We suggest consideration be given to the options to address this, potentially including amendments to the law to enable mutuals to issue perpetual debt instruments with contractual provisions enabling the debt to be written off upon specified points of non-viability being triggered.

Clear delineation of Board and management responsibilities

KPMG agrees with the importance that APRA is attaching to the role of the board in satisfying itself that their institution has a robust and comprehensive risk appetite, risk management and risk culture framework, and that the institution is operating within the requirements set by the Board. However, we stress the importance of maintaining a clear delineation between the responsibilities of the Board and management in relation to risk issues. That is, prudential standards should not result in a blurring of the boundaries between an approval and oversight role (the Board) and an implementation and day-to-day management role (senior management team).

We therefore suggest that this issue be considered by the FSI with a view to ensuring that a clear delineation is maintained and that expectations of directors are appropriate.

Directors' responsibilities derive from the Corporations Act, relevant common law principles and a range of other legislative and regulatory regimes. Companies and directors of companies listed on the Australian Securities Exchange are also subject to its listing rules. For APRA regulated institutions (authorised deposit takers, general and life insurers), additional requirements are imposed through harmonised "behavioural" prudential standards. These have replaced previous industry-specific prudential standards, most notably CPS 510 Governance, CPS 520 Fit and Proper, and CPS 220 Risk Management.

CPS 510 and 520 cover issues of: board structures and composition, directors' independence requirements, audit arrangements, remuneration policy requirements, "responsible persons" and fit and proper policy expectations, and whistle blowing. The requirements of these prudential standards are frequently prescriptive; often they have been longstanding. In some instances, these matters are the subject of disclosure requirements imposed through separate prudential standards. The expected balance between these disclosures and those of the financial accounts has become less clear as regulators have significantly revised and expanded their minimum requirements for risk quantification and capital adequacy.

Exclusions to these behavioural prudential standards do occur in cases of foreign-authorised deposit-taking institutions, and certain categories of insurers and eligible foreign life insurance companies. In the case of foreign-authorised deposit-taking institutions, many of the requirements are the responsibility of a nominated senior officer outside of Australia (SOOA) who will be responsible for overseeing the Australian branch operation. By contrast, exclusions to these prudential standards are not available for small locally authorised regulated institutions and as such potentially impose significant organisational and compliance costs. The uniformity of requirements raises questions as to whether small institutions can satisfactorily address the regulatory requirement that directors and senior management "have the full range of skills needed for the effective and prudent operation of the institution" as required by CPS 510.

CPS 220 is a more recently introduced harmonised behavioural prudential standard that will commence on 1 January 2015. Its requirements include details of the expected role of the Board of directors, which are elaborated upon in the accompanying Prudential Practice Guide CPG 220 Risk Management (still in draft at the time of this submission). KPMG is aware of industry concerns that the described role of the Board in CPS 220 infers a level of managerial ownership by the Board (and SOOA) that is beyond the "gaining of comfort" over the various items listed in this part of the prudential standard, particularly when accompanied by additional requirements for the Board to make an annual declaration to APRA in CPS 220.

APRA has stated it is developing an 'information pamphlet' for new and existing board members to give a concise and plain-English view of what APRA expects of board members in their oversight of prudential matters. It has further advised its intention to perform a stock-take of its existing requirements for boards to assess consistency across industries and whether any requirements are "unreasonable or unduly onerous". These most recently announced developments, while welcome, clearly indicate the benefits to be achieved from regular and more formalised engagement between APRA and industry groups that KPMG has recommended.

Other areas where further regulatory attention may be warranted

Notwithstanding the substantial regulatory initiatives that have been undertaken in recent years, there are some areas where further regulatory attention may be warranted. We briefly list these below. However, in each case, we would stress the need for any new initiatives to be subject to rigorous cost/benefit assessment, including peer review by expert parties outside the relevant regulator.

Possible areas where further regulatory attention may be warranted include:

- *Large exposure limits.* APRA's requirements in relation to large exposures and related party exposures have not been reviewed in recent years. The current limits are relatively high by international standards and are based on total regulatory capital rather than the primary loss-absorbing CET1 category of capital. KPMG suggests that large exposure requirements be reviewed in the context of the BCBS consultation on this subject, with a view to ensuring that Australia adopts appropriate requirements in this area.
- *Recovery and resolution planning.* Although APRA has made a start with its requirements on banks to develop recovery plans, it has generally made less progress in the area of recovery and resolution planning than have the regulators in comparable foreign jurisdictions, especially the US, UK, EU and Canada. This creates a potential vulnerability for the financial system should Australia experience severe economic or financial shocks. In particular, the 'Too Big To Fail' issue largely remains unaddressed in Australia. As a consequence, significant moral hazard and taxpayer risks apply.

  KPMG suggests that consideration be given to the measures required to address these risks, including:

  – strengthening and extending recovery planning requirements;

  – introducing resolution planning;

  – strengthening crisis resolution powers, including bail-in powers; and

  – assessing resolution-funding options to reduce fiscal risks.
- *Stress testing.* Although APRA undertakes stress testing of the financial system, there is scope for enhanced visibility on the nature of stress testing conducted and the results of stress tests. It is suggested the Inquiry consider the scope for increased transparency in these areas in ways that do not identify individual financial institutions.
- *Unregulated financial institutions*. There is currently no statutory framework to require a financial institution that is not prudentially regulated to become regulated. Although there would seem to be no such entities of sufficient size at present to warrant prudential regulation, this could change in the future. We suggest that the Inquiry consider the merit of establishing a framework to enable the authorities to impose prudential regulation on such entities, in particularl when they are considered to be systemically important.

Other matters

Regulation of SMSFs

Under current regulatory arrangements, APRA is the prudential supervisor for superannuation schemes, other than Self-Managed Superannuation Funds (SMSFs). The Australian Taxation Office (ATO) has responsibility for providing limited supervisory oversight of SMSFs. Although there are sound reasons why SMSFs are regulated by the ATO, this does raise an issue as to the adequacy of current supervisory arrangements for SMSFs and the potential risks to which the beneficiaries of SMSFs may be exposed.

KPMG suggests the Inquiry consider whether the existing regulatory framework governing SMSFs provides sufficient protection to beneficiaries, relative to the protection afforded by APRA supervision, and whether modifications to the regulatory framework may be warranted to address any deficiencies. In particular, we suggest that consideration be given to the following matters in relation to SMSFs:

- regulatory objectives;
- consistency/lack of consistency in regulatory requirements between SMSFs and other superannuation schemes, particularly in relation to governance, risk management, and fit and proper requirements;
- requirements for disclosures to beneficiaries;
- the extent and nature of supervision by the ATO vis-a-vis the supervisory approach of APRA; and
- powers and processes to address SMSF breaches of law, etc.

Financial advisers

KPMG notes that there is no centralised system of registration for financial planners/advisers/brokers. This creates difficulties around conducting due diligence on financial planners/advisers/brokers because of a lack of public information about accreditation, investigations by ASIC, disciplinary action, etc. We therefore suggest that the Inquiry consider the case for establishing a centralised system of registration that also contains information about enforcement action, disciplinary action and related matters.

KEY RECOMMENDATIONS

- Strengthening the quality of the regulation-making process, through improved structures to promote effective cost/benefit analysis of regulatory proposals
- Facilitating more whole-of-sector consultation through regular strategic meetings between the Council and heads of industry peak bodies
- Formalising key performance indicators and external performance assessment
- Creating a framework for defining, measuring and promoting financial system efficiency outcomes
- Enhancing the role, of the Council of Financial Regulators (the Council) through statutory recognition and widening the Council's membership to other financial sector regulators
- A more risk-based approach to prudential regulation to allow for greater differentiation within categories of regulated entities. This would relieve smaller entities of disproportionate regulatory burdens
- Clarification of regulatory agencies' roles and responsibilities with greater transparency of policy objectives
- Reassessing insurance capital requirements and prudential requirements for small ADIs, insurers and super funds in the context of cost-benefit analysis
- Assessment of high cost issues relating to the mutual sector – specifically risk weightings under Basel capital framework and bank licensing
- Allowing mutuals to issue perpetual debt instruments with contractual provisions that can be written off
- Re-examining large exposure limits, which are relatively high by international standards, in the context of BCBS consultation
- Ensuring that a clear delineation between the responsibilities of the Board and management in relation to risk issues is maintained and that expectations of directors are appropriate
- Encouraging more progress in recovery and resolution planning
- Enhancing transparency on stress testing of the financial system
- Looking at a framework for imposing prudential regulation on unregulated financial institutions
- Assessing the existing regulatory framework governing self-managed super funds
- Establishing a centralised system of registration for financial advisers

Regional Integration

Promoting greater regional integration and regulatory harmonisation with Asia

Cross-border financial sector integration and harmonisation

The growing development and integration of our economy and financial markets with Asia presents significant opportunities for Australia.

Capitalising on increased trade, capital and investment ties with China, India and other countries in the Asia-Pacific region will require deeper levels of engagement and linkages between our respective financial systems (e.g. capital markets). This stands to benefit Australian businesses seeking capital for growth, as well as for Australian investors, looking to diversify their portfolios and gain access to faster-growing, emerging economies.

These regional interconnections will likely increase in scope and complexity as our financial system and those of our Asian neighbours continue to evolve.

This suggests that greater attention needs to be paid to the scope for, and costs and benefits of, closer integration and harmonisation of regulation between Australia and other jurisdictions, especially within the Asia-Pacific region. This is particularly the case for trans-Tasman integration and harmonisation, given the many inter-connections between the Australian and New Zealand financial systems. In the interests of promoting greater financial system efficiency between Australia and New Zealand, a closer integration and harmonisation of regulatory arrangements would be desirable.

For example, a more harmonised set of prudential, market conduct and anti-money laundering (AML) regulations would help to reduce compliance and efficiency costs for the major banks and insurers, and would facilitate a more coordinated and effective approach to financial system risk management by regulators in both jurisdictions. Likewise, further progress in achieving a mutual recognition framework for financial issuance, product disclosures and other matters would promote efficiencies for entities seeking to operate in both jurisdictions. A more coordinated framework for crisis resolution, including burden-sharing arrangements where necessary, would also be desirable.

These outcomes could be promoted through the establishment of a trans-Tasman Joint Council of Financial Regulators, which would be tasked by the Australian and New Zealand governments to promote greater integration and harmonisation of regulatory arrangements (subject to the primacy of maintaining domestic financial system stability and efficiency outcomes).

Beyond the trans-Tasman dimension, it is important for Australian regulators and government agencies to work with their counterparts across Asia and further afield to explore the costs and benefits of progressively moving towards more harmonised and integrated regulatory frameworks across the region. This is not limited to the permissible recognition of collective investment schemes (see for example ASIC's Regulatory Guide 178), but should extend to more formalised arrangements for regulatory colleges to support the development of common prudential requirements and expectations. Here there are growing challenges as regulators, reflecting the proposals and decisions of the Financial Stability Board (FSB), are expressing more demanding "qualitative" expectations for risk management and governance of boards and senior management.

Although the achievement of this is likely to be a longer-term aspiration, it would serve the interests of Australia and other countries in the region to foster closer integration of the countries' regulatory frameworks and financial systems. This could possibly be pursued in the context of bilateral and multilateral free trade agreements, and could include progressive harmonisation of regulatory and supervisory requirements, and mutual recognition arrangements.

Australia (and Asia-Pacific) influence on international prudential regulation

Much of Australia's prudential supervision framework is, increasingly, driven by international standard-setters – especially the BCBS, IAIS and FSB. Although Australia is represented on these bodies, it is only one voice among many – and a relatively small one in the global context. Accordingly, there are limits to what influence Australia can have on international standards.

Nonetheless, KPMG sees a need for Australia, in conjunction with other countries in the Asia-Pacific region, to seek greater influence on international standard-setting. This would potentially assist to reduce the risk of over-regulation and of regulatory frameworks not aligning to our needs.

To this end, we suggest that consideration be given to:

- the scope for APRA to be appointed to the FSB, joining the RBA and Treasury. APRA is one of only a few G20 supervisors not on the FSB; and
- Australia working with other jurisdictions within Asia to promote greater regional influence on the FSB, BCBS and IAIS (for example, by encouraging a periodic regional rotation of chairing).

Australia as a regional financial centre

The "Johnson Report" in 2009, *Australia as a Financial Centre – Building on Our Strengths*, included a range of positive recommendations relating to tax and regulatory matters that need to be addressed in order to promote Australia's competitiveness as a regional financial centre and capitalise on the "Asian Century".

Progress on the implementation of the recommendations has been slow and therefore, KPMG encourages the Government to prioritise the implementation of these measures (as outlined later in the submission).

KEY RECOMMENDATIONS

- Facilitating integration and harmonisation between Australia and other jurisdictions, particularly in Asia Pacific
- Establishing a Trans-Tasman Joint Council of Financial Regulators to promote integration and harmonisation of regulatory arrangements between Australia and New Zealand
- Exploring the scope for APRA to be appointed to the FSB, joining the RBA and Treasury
- Australia working with other jurisdictions within Asia to promote greater regional influence on the FSB, BCBS and IAIS
- Encouraging the Government to prioritise the implementation of the tax and regulatory recommendations included in the Johnson Report

Funding and Investment

Enhancing diversification of funding and supporting superannuation investment in long-term asset classes

The Australia's financial system has relied heavily on short-term wholesale funding, and the GFC demonstrated that this funding cannot necessarily be relied upon in a crisis situation.

There are a range of options that could be explored to encourage "stickier" and longer term funding by and for the Australian financial system. In many cases, only minor changes to tax settings (in either removing impediments or distortions between asset classes) may have significant effects on capital flows, opening up more opportunities for offshore funding and access to more domestic opportunities.

Provision of long-term capital through the superannuation system

Inherently, the long-term savings of investors through the superannuation system are the natural source of long-term funding of Australia's growth, whether that is infrastructure investment, long-term corporate bonds or other investment channels.

From a system perspective, the relevant funds are effectively available for investment by superannuation funds until (at least) retirement. However, at least anecdotally, superannuation funds require significantly more liquidity in their investment portfolios than required by operational and prudential requirements. In addition, it seems that only a relatively small proportion of assets held in superannuation funds are channelled into Australian infrastructure or corporate funding. In part, this may reflect a need for superannuation funds to achieve an appropriate geographic and other diversification of risk and the need for at least a proportion of assets to be in liquid or readily liquefied form.

Notwithstanding these considerations, we see a need to assess whether there is scope to better meet the investment needs of superannuation funds while also seeking to ensure that the wealth held in these funds are more accessible for Australia's economic development and growth.

On the premise that Australia's economy would be improved through increased access to long-term capital, it is necessary to examine factors inhibiting the ability of superannuation funds to provide long-term capital.

Role of "choice"

Australians, through the superannuation system, have the ability to "choose". Firstly, there is choice between superannuation funds, and secondly, there is choice between investment options within a particular superannuation fund (i.e. there is an ability to switch, for example, from an aggressive to a balanced investment option).

Although (inter-fund) "choice" is an important design feature of the superannuation system (otherwise, there is a risk of individuals being trapped in low-performing superannuation funds), there is a question as to whether the existence of these choices forces superannuation funds to invest short term, thus foregoing the premium investment returns that could be available for longer term financing ("the liquidity premium").

For example, where a superannuation fund must have the ability to price an investment option on a daily basis (either for entries or exits), there is an inherent conflict with holdings of longer-term assets, particularly unlisted assets with discontinuous pricing (i.e. relying on periodic external valuations). For example, where these valuations lag the market, there is the risk of an internal "run" on the superannuation fund to or from cash-based options.

The challenge is that in return for offering what is a rarely accessed "choice", all investors in the fund can indirectly suffer due to lower investment returns resulting from the foregone liquidity premium, i.e. the need for funds to invest (at a premium) for the minimum term of investment rather than a more balanced or longer term view.

As such, mechanisms should be explored as to whether "lock in" products can be offered by superannuation funds. For example, an investor may choose to forego the ability to "switch" (either investment options or funds) for a period, and/or agree to a longer notice period for any "switch". This type of product should facilitate increased asset allocation to infrastructure, venture capital/private equity and other types of longer term, less liquid investment classes.

Foreign and domestic institutional investment in infrastructure

Over the last five years in particular, there has been significant investment from foreign pension plans and sovereign wealth funds into Australian infrastructure.

However, the current tax settings in relation to investments in infrastructure are very complex and often require intricate structuring to deal with a range of legacy tax settings.

In addition, there can be significant differences in tax profile depending on the exact legal status of an offshore fund (whether a trust or other legal entity, whether a pension fund or not, whether a sovereign fund or not). There is also the risk that tax settings put Australian superannuation funds at a disadvantage to particular types of offshore funds.

The complexity of these settings increases the cost of capital on these projects, as institutions will conservatively model taxation in determining the purchase price. This can include modelling the risk of changes in taxation settings over the term of long-term investments. (Noting that when the tax ultimately levied is less than that modelled, there is effectively a windfall gain to the investor – conversely, where tax laws are changed adversely, there is effectively a windfall gain to the vendor of the infrastructure project).

This requires the tax regime in relation to infrastructure investment to be stable, sustainable and non-distortive.

Offshore retail funding

The taxation system settings on interest withholding tax encourage reliance on wholesale funding (no withholding tax) rather than offshore retail funding (10% withholding tax). There may also be regulatory impediments to offering retail banking products in other countries.

In the context of the "Regional Funds Passport" initiative (a recommendation of the Johnson Report), this is the ideal time to consider whether tax and regulatory settings can be reset to allow Australian financial institutions to raise retail funding in other countries. Arguably the demand from the region for Australian bank type products is higher than the demand for equity type products, and Australia will only obtain the full benefit of a regional passport initiative if it includes bank type products.

In the context of cost to revenue, removal of interest withholding tax is likely to be "revenue positive": given that this is likely to be a substitution of offshore wholesale funding, the loss of interest withholding tax revenue will be minimal. On the other hand, Australian financial institutions would have increased access to cheaper and stickier funds than is currently the case.

Long-term and inflation-linked bonds

As noted in the Henry Tax Review, bonds are taxed on their nominal yield. This effectively means that the return over the real return is taxed "on the run". This should be contrasted with returns on equities, where capital growth (including the inflation component) is taxed only on disposal, and then often on a concessional basis (Capital Gains Tax discount, crystallisation in pension phase, etc). This provides a tax disadvantage to investment via long-term bonds.

In relation to indexed or inflation-linked bonds, similarly the inflation element is taxed as it accrues rather than on repayment at the maturity of the bond (under the "Division 16E" and "Taxation of Financial Arrangements" (TOFA) provisions).

These tax settings should be reviewed to determine whether there should be a rebalancing of the treatment of long-term debt instruments versus the treatment of equity. This would support the growing corporate bond market, as well as the ability of Government to issue attractive long-dated (and potentially inflation indexed) bonds (which are ideal assets to support increased annuitisation for retirees – refer further below).

Offshore wholesale Islamic financing

As Australia seeks to diversify its funding sources, as well as integrate more with the Asian region, minor changes to taxation rules should allow access to the Malaysian Islamic financing hub.

As noted elsewhere, wholesale funding is not subject to interest withholding tax. However, features of Islamic financing mean that it is not entirely clear whether equivalent Islamic financing falls within these concessions.

A legislative amendment to clarify that "sukuk" bonds have comparable treatment with conventional bonds would free up access to a new funding source for the Australian market.

KEY RECOMMENDATIONS

To develop a deeper long-term funding market, a range of options is available. To address this gap, we recommend:

- Facilitating the provision of long-term funding through the superannuation system by exploring lock-in products
- Enabling access to the wholesale Islamic financing hub through minor tax amendments
- Creating access to foreign and domestic investment for Australian infrastructure by simplifying tax settings
- Facilitating access to the offshore retail funding market through recalibrating tax and regulatory settings – particularly through removing interest withholding tax
- Reviewing tax settings on long-term and inflation-linked bonds with a view to rebalancing treatment of long-term debt versus equity

Longevity Risk

Re-purposing the superannuation system to better address longevity risk

A key development in the Australian financial system since the 1997 review is the maturity of the superannuation system. As the first "baby boomers" start retiring, the superannuation system is transitioning from an investment-based system to a pension-based system.

The system has been highly successful in its role of pooling investment funds. This success may create a challenge in moving to the pension phase, when the superannuation system will increasingly be looked to by retirees as a means of protecting against future expenditure needs, including protecting against increases in longevity.

There is an opportunity to create incentives to manage longevity risk, and encourage the product development and annuitisation required in a transition to a pension-based system. This is urgent given the looming demographic position of retirement of the "baby-boomers".

Supporting management of longevity risk

Role of the superannuation system as an intermediary assisting individuals to manage their risks

As noted above, the superannuation system has primarily acted as a conduit for investment on behalf of and in the best interests of members.

More recently, we have seen the superannuation system increasingly take on a role as financial intermediary in relation to management of certain life risks, through intermediating in the life insurance market (through the provision of "group life" policies which can be accessed by individual members).

As individuals retire, there is a similar role for the superannuation sector to assist its members in obtaining access to insurance against longevity risk, either directly from life insurance companies, or indirectly through superannuation funds being able to access a wholesale market on behalf of individuals. This will also take pressure away from the social security system, through reduced reliance on the age pension.

Current impediments

Superannuation was created to supplement the age pension as one of the three pillars of the Government's Retirement Incomes Policy. The current framework (a mixture of tax, social security and superannuation withdrawal rules, as well as the "backstop" ability to rely on the age pension) provides no incentive to individuals to self-manage their longevity risk, and in fact provides disincentives.

For example, if a life insurance company wished to offer a longevity insurance product which pays an annuity on obtaining a certain age (for example, 80 years old):

- in at least the period until retirement, and possibly even after retirement, the life insurance company will be taxed disadvantageously on underlying investment earnings (effectively treating an insurance product as an investment product, with taxation of the investor's return as well as corporate taxation of the margin);
- on retirement, the individual will be entitled to withdraw from the product, creating "adverse selection" risks;
- this product would not fit neatly into any of the Superannuation Industry (Supervision) [SIS] pension categories, causing other SIS and tax issues; and
- there is a complex interaction with various social security tests.

The legislative change to allow a longevity insurance market (or deferred lifetime annuity) is minimal. In addition, there should be minimal or no cost to the revenue to allowing these products (even on a first order revenue effect basis).

We also note below the potential recalibration of the superannuation tax concessions to provide a relative taxation advantage to individuals who manage their longevity risk. For example, the current full exemption in pension phase could be retained only for individuals who have either fully annuitised their superannuation balance or have used those funds to purchase an annuity of at least equal to the aged pension.

In addition, by encouraging more individuals to manage their longevity risk, this will further facilitate the development of the market – as more risks are pooled, the cost of insurance is reduced (for example, there is less risk of "adverse selection" when there are more individuals seeking insurance), as well as there being greater incentives for product innovation.

Facilitating product innovation

Currently there are very few issuers of product that protect against longevity risk (e.g. lifetime annuities or deferred lifetime annuities). Putting aside Government and corporate defined benefit funds (generally closed to new members) and the aged pension itself, there are only one or two industry participants that provide these products.

Part of this can be attributed to the demographic trend that, until now, superannuation has been primarily an investment vehicle rather than a way of hedging future expenditure needs. In addition, it is only now that retirees will have had a significant portion of their working life under the superannuation guarantee system, i.e. retirees are only now having sufficient balances in superannuation to make their superannuation savings an important part of their retirement strategy.

One of the current impediments to product innovation generally and, in particular, in relation to products to help manage longevity is the difficulty in rationalising "failed" products. It can be difficult to develop and offer an innovative product where there is no guarantee of its success, and a failed product must be left in place for decades or more.

A sensible product rationalisation mechanism can remove a large impediment to product innovation. Without it, there is a significant risk that an offeror can be left with a small legacy book for a long period.

Addressing arguments against annuitisation

One of the arguments often raised against encouraging or compelling a level of annuitisation is the difficulty for financial institutions in managing these long-term risks. In fact, this should be seen as an argument for bringing these risks within the financial system: if it is difficult for institutions to pool and manage these risks on behalf of many individuals, it is much more difficult for an individual to effectively self-insure these risks.

Superannuation taxation incentives

Taxation incentives are a powerful tool to encourage behaviour without resorting to compulsion. As such, taxation incentives can play an important role in encouraging particular forms of investment/risk management across the financial system.

The taxation incentives applying to superannuation should be re-examined to ensure that they are encouraging the appropriate behaviour and non-distorted capital allocations. The current asset allocation in Australian superannuation funds are by global standards heavily skewed to investment in Australian equities (and away from fixed income) – this is arguably encouraged by the existing taxation incentive structure applicable to superannuation.

In this regard, there is a question as to whether the existing taxation incentives should be rolled back, at least partially, to provide space for relative greater incentives for appropriate behaviour (effectively a two tier approach to tax concessions in pension phase, with a base level of concession for ordinary savings and an enhanced level of concession for risk mitigating investment strategies).

For example, the current tax exemption in the pension phase could be conditional on annuitisation or investing in other products which manage longevity risk. Where an investor does not manage longevity risk, they would continue to be taxed on an accumulation phase basis.

Recalibration of existing concessions

Some particular features of the superannuation taxation system that should be examined include:

- full tax exemption in the pension phase

This provides no relative incentive to invest in longer-term assets or to reward appropriate management of longevity risks. For example, this concession does not distinguish between investing prudently to manage longevity (e.g. through investment in an annuity or long-term bonds) and a speculative geared strategy into equities or a single property).

- no taxation event on transition to pension phase

This means that unrealised gains accruing in accumulation phase will never be taxed (not even on ultimate realisation of the asset) when an individual can hold the assets until after retirement.

This provides a competitive advantage to SMSFs and also an advantage to long-term assets (such as residential property) within those SMSFs (and, in particular, negatively geared residential property).

- full refundability of imputation credits

In pension phase, there is full refundability of imputation credits regardless of the overall position of the fund. This means that for the same coupon yield, a debt instrument or infrastructure investment must yield approximately 40% more than a franked dividend yielding stock, even ignoring the capital growth implicit in equities.

This encourages the current large weighting to equities in pension phase.

Separately, as more of the Australian stock market is owned through superannuation vehicles, and of that holding more is held in pension phase, this system puts great pressure on the corporate tax base (which will increasingly be refunded through the imputation system).

KEY RECOMMENDATIONS

As the Australian market transition from an accumulation-based market to a pension-based market as the baby boomer generation approaches retirement, we urgently need to encourage appropriate management of longevity risk and product innovation.

Our recommendations include:

- Supporting the management of longevity risk through appropriate insurance options
- Improving incentives to self manage longevity risk, such as provision of a relative tax advantage
- Product rationalisation to facilitate innovation
- Addressing arguments against annuitsation by bringing these risks into the financial system
- Re-examining tax incentives on super to ensure appropriate behaviour

Digital, Payments and Technology Risk

Enabling the take-up of digital and new payment services to boost productivity and addressing emerging technology risks

The Terms of the Reference of the Inquiry aim to identify and consider the emerging opportunities and challenges that are likely to drive further change in the global and domestic financial system, including the role and impact of new technologies, market innovations and changing consumer preferences and demography.

In this section, KPMG provides a perspective on the evolution of financial services created by technological innovation and customer-driven change, developments to the payments system and emerging technology risks that need be addressed, such as cyber crime. Given the long-term effects of these trends, we provide these observations as important context for the Inquiry as it deliberates potential policy recommendations (e.g. regulatory, competition, etc).

The impact of digital on financial services

There are a range of trends and developments driven by the 'digitisation' of financial services that will bring about significant transformation of the industry and business models in the future. A summary of these points are provided below (with a detailed description set out in the Appendix).

- *Pressure on branch footprint and operating models present challenges and opportunities*. Financial institutions, particularly banks, are likely to alter their branch distribution and operating models as they see digital channels as a growth engine that fulfils consumer demands and allows them to realise significant productivity improvements and greater cost efficiencies throughout their organisations.
- *Growth in digital as a primary channel.* Australia is leading the rapid uptake of smart phones and tablets, with the second highest smart phone penetration level globally. While the 'digital revolution' has drastically increased electronic transaction volumes, KPMG research confirms that most consumers trust their banks most when it comes to making financial transactions over a mobile device.
- *Move away from face-to-face (F2F) advice for certain segments.* Financial/wealth advice has historically been a face-to-face activity for financial institutions, with a key focus on building sustainable relationships with customers. This traditional, face-to-face interaction and relationship building will continue, but alternative (i.e. electronic) channels will rise for more complex advice and transactions in order to keep up with customers' multi-channel demands. High value, low volume advice and transactions will no longer be reserved for face-to-face transactions, with some financial transactions (e.g. home loans) already migrating away from face-to-face.
- *Greater levels of self-service.* Simple self-service end-to-end online solutions that minimise repeat data entry and capitalise on insight and information held by the bank resonate well. Due to their face-to-face nature, branch services will increasingly become a "showroom" focused on sales, customer education and advice on complex transactions such as mortgage and loan applications. Greater development and promotion of Straight Through Processing (STP) standards will minimise human touch points, errors and costs, further reducing staff overheads and transaction processing time.
- *Changing competitive environment*. With the changing environment and lowered barriers to entry comes the growing risk of disintermediation for traditional financial services providers. Nimble innovators such as PayPal, Google Wallet and other mobile banking platforms threaten to challenge long-entrenched retail banks in keeping up with their customers' demand for convenience, personalised service and wireless interconnectivity. New players, such as aggregators, payments providers and the emergence of 'peer-to-peer' lending, which directly matches up people and firms in need of cash with investors, are also emerging as potential threats.
- *Fraud and security*. The rapidly increasing dependence on digital data connectivity and storage demands large investments to be made in securing and efficiently understanding the data entrusted by consumers. Particularly in retail financial services where personal data is sensitive, it will be

imperative for financial institutions to get it right as any mistake could impact their reputation and credibility in the instant it takes for a dissatisfied customer to access social media.

- With digitally enabled changes in the financial services industry set to accelerate over next decade, a flexible regulatory framework that is responsive to changing consumer preferences, allows for further product and service innovation, and provides for a safe and sound system through the appropriate regulatory oversight of new entrants to the marketplace will be a critical enabler and risk mitigant.

New payments services

Australia has one of the most advanced payments systems globally. The regulatory framework for the payments industry performed well throughout the GFC and on a range of measures (i.e. access, payment methods, innovation and speed/diversity), compares favourably with many international jurisdictions. This in part is a result of an effective and constructive level of regulator (the RBA) and industry cooperation, allowing for strong levels of coordination and competition. An example of this is the move towards the development of real time payments infrastructure, the New Payments Platform (NPP).

KPMG contends that the current regulatory structure of the payments industry in Australia works well (and consistent with our earlier observations), is not in need of significant change. In addition, KPMG considers that the RBA's role, as the primary regulator of the payments industry, should be retained.

However, with the emergence of new technologies and non-traditional entrants into financial services likely to increase substantially in the future, consideration should be given to an appropriate level of regulatory oversight of new entrants into the payments industry.

To this end, setting a clear high-level policy framework, developed in conjunction with the RBA and industry participants (existing and new participants), is a sensible mechanism for creating the most appropriate policy and regulatory settings, to ensure the right balance of stability, efficiency and competition objectives.

Emerging technology risks

Cyber Security

Cyber security has the potential to be a systemic risk to the financial system. The evolution of the financial system is inevitable and traditional financial systems are increasingly interconnected with electronic global networks that are constantly under attack.

Some current trends of financial system interconnectivity and dependency include:

- Generation of virtual currencies outside the control of governments;
- Movement and processing of financial data through and across multiple jurisdictions;
- Fast time-to-market of new technology-based products and services;
- Consumer based services operating on less robust mobile computing platforms;
- Proliferation/commercialisation of malware;
- Multiple service providers interacting to fulfil product delivery obligations; and
- The desire for faster clearing of funds between individuals.

With cyber security risks inherent in all these activities (and more), the information technology industries continually seek to minimise risks for their business and consumer customers. For example, Apple successfully established a safe, regulated and quality controlled framework for electronic distribution as an alternative to unsafe and unregulated piracy. This demonstrates how creative thinking can provide a level of security to an otherwise unregulated market and provide opportunity for commercial success.

The challenge is often in the implementation of technology and supporting/surrounding business processes.

Broaden the adoption of industry standards and guidelines

Financial services institutions and many large corporations operate differing technologies – often legacy systems with limited potential to enhance cyber security provisions – which can create a "weakest link" opportunity with consequential damage to the economy.

Empowering financial regulators to oversee cyber security standards adoption for corporations that deal with or process large numbers of consumer generated financial transactions could be considered as a potential solution. For example, the UK Government recently sponsored a program of independent third party cyber security assessments (http://www.telegraph.co.uk/technology/internet-security/10202772/MI5-and-GCHQ-urge-FTSE-350-to-step-up-cyber-defences.html), with the results of the assessment enabling corporate remediation, but also allowing the Government to be better informed of the cyber security readiness of the industry.

Assess the likelihood and response capability of an industry-wide cyber attack

IT systems are evolving quickly and the ability to keep data safe and provide new efficient services is a challenge for many industry participants with new products, internal and customer facing applications (including applications used on mobile devices).

Individual regulated financial services institutions adopt varied positions in relation to cyber security. A significant successful attack on one entity can impact the industry overall and potentially undermine consumer confidence. Numerous financial services institutions have undertaken initiatives to strengthen cyber security, and in some cases have conducted crisis management scenarios to test and validate their individual preparedness and response capability.

To date, however, there has been no industry-wide exercise to validate overall cyber security and vulnerabilities that might simultaneously impact multiple participants. Therefore, KPMG recommends that multiple authorities (e.g. Department of Finance, Treasury, Attorney-General's Department, Australian Security Intelligence Organisation (ASIO), Australian Signals Directorate (ASD), Australian Cyber Security Centre (ACSC) , APRA, RBA and ASIC) coordinate and/or participate in a whole-of-industry exercise.

KEY RECOMMENDATIONS

- The current regulatory structure of the payments industry in Australia works well and is not in need of significant change.
- The RBA's role as the primary regulator of the payments industry should be retained.
- With the emergence of new technologies and non-traditional entrants into financial services likely to increase substantially in the future, consideration should be given to an appropriate level of regulatory oversight of new entrants into the payments industry.
- Setting a clear high-level policy framework, developed in conjunction with the RBA and industry participants (existing and new participants), is a sensible mechanism for creating the most appropriate policy and regulatory settings, to ensure the right balance of stability, efficiency and competition objectives.
- Empowering corporate regulators to oversee cyber security standards adoption for corporations that deal with or process large numbers of consumer generated financial transactions
- Assessing the likelihood and response capability of an industry-wide cyber attack with a view to creating an industry-wide response

Conclusion

The timing of the Inquiry is highly significant in terms of the strength and ongoing development of Australia's economy, financial system and regulatory architecture. We're far enough removed from the GFC to have the objectivity to address the issues around funding and systemic risk that were highlighted, yet close enough to maintain motivation to strengthen the systems that served us so well throughout that experience.

The world is changing profoundly as broad demographics shift and change the fundamental things consumers want our of their financial system; as market systems globalise and become more interconnected; and as technology facilitates a revolution in consumption and communications.

Looking forward to the next decade (and beyond), there are both major opportunities and risks associated with the level of change that is likely to occur. Australia has historically had an excellent track record of regulating for change and creating the frameworks and systems needed to ensure our system is robust and yet flexible enough to encourage innovation. KPMG is confident that our already sound financial system and regulatory architecture will be even further enhanced by the Inquiry.

We encourage the Inquiry to focus on five key outcomes that will underpin stable economic growth. These include:

- improving our regulatory framework to achieve the balance between stability, growth and efficiency;
- promoting greater regional integration and regulatory harmonisation with Asia;
- enhancing diversification and supporting superannuation investment in long-term assets;
- re-purposing the superannuation system to better address longevity risk; and
- enabling the take-up of digital and new payments services to boost productivity and deal with emerging technology risks.

We believe that creating a framework that can facilitate these five broad outcomes will maintain and further improve Australia's leading regulatory and financial systems.

Appendix

The impact of digital on financial services

Pressure on branch footprint and operating models

The universal banking model is in a significant need of change and the branch footprint is being pressured to justify its continued relevance and growth. This pressure is driven by:

- *Dissatisfaction with the branch experience*. According to a recent KPMG survey, 54% of customers rate their branch experience at 7 out of 10 or better. Younger customers are less satisfied with their branch experience: 46% of 18-24 and 25-34 year olds rated their experience at 7 or higher, compared to 50% of 35-44 year olds, 55% of 45-54 year olds and 64% of 55+ year olds. Australian banks are seeing an annual drop in core transaction volumes of up to 10% (falling), and statistics show that the average Australian customer makes only 12 branch visits per year.
- *Changing demographics*. Driven by "youth affluent" professionals, the next generation is embarking on 40-to-50-year journeys as workers, consumers, savers, borrowers and investors. The Gen Y segment is positioned to become the wealthiest generation to date and by 2020 will form one-third of the Australian workforce. Gen Yers are familiar and intensive users of online and mobile banking, visit branches infrequently and avoid traditional across-the-counter transactions.
- *Changing ways of interaction*. Only 10% of younger respondents ranked branch interactions as one of three ways they wanted to interact with their bank in the future; and one in five said they couldn't see themselves ever using a branch going forward.

As banks alter their branch footprint and operating model they are seeing the digital channel as the growth engine that both fulfils their customers' demands but also allows them to continue the focus of driving efficiencies throughout their organisation.

Growth in digital as a primary channel

Advancing digital capabilities is the main driver for change across industries. For many Australian banks, mobile transactions have overtaken ATMs as a preferred channel. However, while basic remote access and a social media presence have become a minimum expectation of consumers, it remains critical. This growth has been driven by:

- *Changing beliefs around security*. The digital revolution has drastically increased volumes and capabilities in geo-demographic and personal data collection. Around 90% of respondents in KPMG's Consumers and Convergence 5 Survey (2011) are concerned about security of their personal identifiable data. However, "under the right circumstances" 62% of those respondents demonstrated willingness to have their online usage tracked in order to gain better service or valuable deals. International KPMG research supports this, finding that "53% of consumers trust their banks most when it comes to making financial transactions over a mobile device".
- *Increased smart phones and tablets*. Australia is leading the rapid uptake of smart phones and tablets, with the second highest smart phone penetration level globally. Some 60% of the population access the internet on a mobile phone, 7.6 million use a smart phone and 4 million use mobile banking. According to research conducted by Australian Communications and Media Authority (ACMA), the activity recording the largest increase in mobile usage over the past year is banking and finance, up 10%.
- *Reduced costs*. Everyday transactions including basic accounts, transfers, balances, follow-up communications and ongoing relationship management, will be heavily impacted by digital and demographic migration. A banking transaction through a branch typically costs US$4.25 compared to a few cents through mobile banking.
- *Video banking*. Face-to-face video services such as Skype, Facetime and YouTube have created a more fertile environment and acceptance of video conferencing. Accessible, low-cost options and new capabilities offer freedom to both banks and customers by opening access to knowledge specialists in any location and significantly reduce cost and delay inefficiencies.
- *Changing demographics*. In targeting the younger demographic, it is sometimes assumed that social media is the preferred medium. However, the KPMG Young professionals – a wakeup call survey

reveals that 65% of 1,300 respondents stated they would not want their bank to interact with them this way. On the contrary, 49% ranked mobile and online in the top three ways they want to interact with their bank. Japan-based Jibun Bank placed mobile phones at the centre of their strategy in order to target the Gen Y segment. Within four years of operation, they had over 1.5 million clients, 60% of which were in their 20s and 30s.

Move away from face-to-face (F2F) advice for certain segments

Financial advice/wealth advice has historically been a face-to-face activity, with a key focus on building sustainable relationships with customers. This face-to-face interaction and relationship building will continue, but alternative channels must be put in place for more complex advice and transactions in order to keep up with customers' multi-channel demands. High value, low volume advice and transactions will no longer be reserved for face-to-face transactions, with home loans transactions already migrating away from face-to-face.

Impact of social media

The "Social, Digital & Mobile Worldwide in 2014 Report" (produced by We are Social) states that there currently two billion active social network users globally and 1.184 billion users on Facebook alone. The force of social media as a driver of social thought and connectivity is undeniable, and must be considered for its effect on marketing, cost, and the delivery of customer service.

The force of this change is driven by:

- *Deeper engagement to the market*. Social networking has the potential to build increased loyalty and brand awareness, particularly in younger or unbanked market segments. Emerging tools such as "gamification" (the use of games or game elements) and the weight of social reputation have substantially expanded the marketer's toolbox to drive awareness as well as sound financial literacy and behaviour. For example, Citibank's recent launch of 'Thank You Points' on Facebook allowed their customers to earn points based on their use and service holding, thus increasing the bank's professional and social visibility at minimal cost.
- *Convenience*. Social media creates a hub of convenience for customers and offers banks an existing platform to leverage. The convenience for banks as a low cost, high touch channel is apparent, but it comes hand-in-hand with possible reputational risk, careful handling of customer expectations and a revised service delivery model.
- *Customer service opportunities*. Only a fraction of customer complaints travel through official channels but customers do not hesitate to use social media to let other customers and friends know how they were treated. Connectivity allows banks to listen to their customers' public conversations, identify complaints (for example, by tracking tweets) and where appropriate, attempt to resolve them proactively in reduced timeframes.

Changing operational requirements to meet omni-channel expectations and customer-centric targeted offers

Ownership of the customer experience has shifted from the traditionally formidable banks to the digitally aware, time-poor and empowered customer. Customers expect their channels to be in constant communication to keep track of their information, needs and wants; and instantly and seamlessly provide "unique customer experiences". These requirements are being demanded to respond to:

- *Changing customer demands*. In delivering great customer experience, customers are unsatisfied with merely "getting it right" and "being nice". Trained to expect instant gratification and flexibility, customers demand professional and knowledgeable resources; useful information to be made easily accessible; proactive conversations initiated by their banking institutions; and out-of-branch options tailored specifically to them. Simple self-service end-to-end online solutions that minimise repeat data entry and capitalise on insight and information held by the bank resonate well. Due to their face-to-face nature, branch services will increasingly become a "showroom" focused on sales, customer education and advice on complex transactions such as mortgage and loan applications.
- *Changing competitive environment*. With the changing environment and lowered barriers to entry comes the growing risk of disintermediation. Nimble innovators such as PayPal, Google Wallet and other mobile banking platforms threaten to overtake long-entrenched retail banks in keeping up with their customers' demand for convenience, personalised service and wireless interconnectivity. New

players, such as aggregators, payments providers and the emergence of 'peer-to-peer' lending, which directly matches up people and firms in need of cash with investors, are also emerging as potential threats. In the UK, nearly 75% of Britons said they'd consider using a peer-to-peer website to borrow or lend. The UK Government also recently announced four peer-to-peer lenders will be given £55m of taxpayer money.

- *Cross-buying*. Customers increasingly use online price and product-comparison tools, and are more comfortable "cross-buying" products from several financial institutions, rather than awarding all their business to their main bank.
- *The need for more targeted offers*. A small but growing number of banks are already mining their customers' activities to deliver highly targeted services and promotions. Tracking data-rich social networks (for likes, dislikes, preferences, recommendations from network friends) as well as other sources for spending habits and product preferences will lead banks to probable cross-sell opportunities of products and entire suites specifically tailored to their customers. For example, allowing banks to vary their interest rates based on each customer's potential profitability and value.
- *Customer centric design*. More organisations are taking an 'ethnographic' approach to their customer research. This involves close observation of clients and their habits rather than simply asking via surveys. To date these techniques have yielded a range of solutions and designs aligned closely to customer needs. We anticipate that this approach will grow in prominence.

Potential outcomes

Branch footprints will change over the next five years. Though it is unlikely that branches will disappear altogether, the future may require a reduction of up to one-third the present footprint. There are strong indications that two important changes will be made. Firstly, it will become smaller, fragmented and decentralized and secondly, rich data and technology will need to be optimised and integrated seamlessly across multiple channel offerings to deliver an improved customer experience.

- *Relationship centres*. Existing bank branches may need to modernise to become aesthetically designed, lighter "relationship centres" with knowledge sessions, full-self-service kiosks and video calling hubs for complaint resolution. In-branch staff will be replaced by tablets offering 'off the street' clients a direct portal to the bank's social media offerings. Each diverse format will blend digital and in-person channels to best capture the opportunities of its particular trade area and enhance customer experience, achieve efficiencies at scale or both.
- *Location is key*. The reduced branch network will emphasise location-specific decision-making. Taking the lead from retail chains such as McDonald's and Starbucks, banks are likely to supplement network design decisions with local knowledge and statistical methods. The identification of key local markets, influential factors for maximum branch performance and high-potential new locations will guide the assessment of existing and new key locations.

Examples:

- Turkish bank, ZiraatBank has developed a remote banking format to respond to the needs of its customers in congested urban locations by deploying up to 1,000 video banking pods in towns, shopping centres, railway stations and airports. The format offers a considerable cost saving when compared with full-service branches, delivering improved customer access, not only through providing banking services in non-traditional locations, but also as a result of the fact that they are open round the clock, 365 days a year.
- Citibank in Asia has begun implementation of Citibank Express, its next-generation ATM equipped with online banking connection, video conferencing and biometric identity authentication. Customers are able to make basic transactions such as applying for a loan or obtaining a cashier's check.

Large investments will be needed

- *Straight through processing (STP) to achieve simplification and end-to-end clarity around key business processes*. Strong downward pressure exists on user fees with the introduction of low or no cost social media banks and financial advice. The development of STP standards aims to minimise human touch points, errors and costs in order to reduce staff overheads and processing time. In Australia, the focus has been to look to customer-centric industries such as fast-moving consumer goods with beginning-to-end lines of responsibilities.
- *Fraud and security*. The high dependency on digital data connectivity and storage demands large investments to be made in securing and efficiently understanding the data entrusted by the customer. Particularly in the retail banking space where data is sensitive, it will be imperative for banks to get it right as any mistake could irreversibly destroy their reputation and credibility in the instant it takes for a dissatisfied customer to access social media.
- *Data analysis*. Rich opportunities exist in understanding customers' needs. While many of these are shifting with the "youth affluent" and Gen Y, other trends do move with the economic pulse and cultural shifts. The rate at which individuals' data habits can be captured and converted will also be an important measure of success in the future of banking.
- *Digital capabilities*. Video banking can be utilised to deliver value in education with interactive videos, open access to specialists unrestricted by geographical constraints and expensive overheads, and more effectively utilise scarce sales and technical talent. KPMG's Retail Banking Video Advice: What does the future hold? surveyed over 90% of major banking and deposit-taking institutions in the Australian domestic retail banking market, finding that all institutions are investing resources into video banking technology. In fact, 22% of institutions surveyed had already implemented some form of video banking, 11% would in six months to a year, 44% would in one to two years, 11% in three years and 11% are still awaiting pilot results to decide.

Migration of the "sticky few"

- While the rise of tablets, faster communications speeds, improved security and smart phones have contributed towards migration away from traditional channels, the move has plateaued in some segments – the modest but material "sticky few".
- *Their importance*. Banks will seek to understand the root cause of this resistance in order to better approach and serve this market. The group is particularly important in retail banking as they require high-cost support of branch visits, contact centre calls and paper-based statements. Behavioural economics is an innovative tool that can help banks better understand these underlying decision-making processes and thus more precisely manage channel migration. Underlying drivers can include novice behaviour, fear of failure, lack of awareness and perceived ease.

Contact us

Adrian Fisk
Partner, Head of Financial Services
+ 61 02 9335 7923
adrianfisk@kpmg.com.au

Ian Pollari
Partner, Financial Services
+ 61 02 9335 8408
ipollari@kpmg.com.au

www.kpmg.com.au

March 2014