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31 March 2014

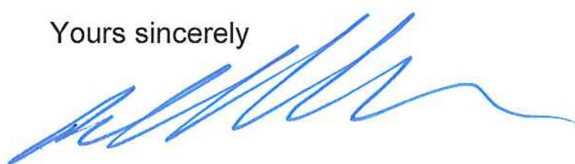
Head of Secretariat
Financial System Inquiry
The Treasury
Langton Crescent
PARKES ACT 2600

Macquarie Group Submission to the Financial System Inquiry

Please find attached Macquarie Group's submission to the Financial System Inquiry. We would be pleased to meet with members of the Inquiry panel to discuss our submission in more detail.

Should you have any queries please contact Trevor Burns in Macquarie's Government Relations on +61 2 6103 3112.

Yours sincerely



Patrick Upfold
Chief Financial Officer
Macquarie Group Limited

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Financial System Inquiry

Submission by Macquarie Group

31 March 2014

FORWARD thinking

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1. Overview

In announcing the Financial System Inquiry, the Australian Government has stated its desire for a 'root and branch' examination of the nation's financial system. This review is timely given the significant and wide ranging developments in the Australian and global financial systems since the Wallis Inquiry, not least the global financial crisis and subsequent regulatory developments.

The terms of reference for the Inquiry are appropriately broad, touching on many aspects of the financial system. The Inquiry is charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support economic growth, including how Australia funds its growth, how domestic competition and international competitiveness can be enhanced, and the current cost, quality, safety and availability of financial services, products and capital for end users.

As a global financial institution headquartered in Australia with approximately two thirds of its business outside Australia, Macquarie is well placed to provide input to the Inquiry on several aspects of its terms of reference, and in particular:

- **Competitiveness** - policies to improve Australia's competitiveness as an international financial centre and facilitate export of financial services;
- **Regulation and Compliance** - achieving balance between mitigating risk and protecting consumers, and enabling innovation and efficiency that improves choice and lowers costs throughout the economy;
- **Growth** - initiatives to help fund Australia's economic growth; and
- **Technology and Innovation** - impacts of technological change and innovation, and how these can be enhanced, while at the same time ensuring Australian consumers remain protected as technology develops and new providers enter the market.

Australia has a well developed and highly regarded financial system, with a skilled workforce, established rule of law, proximity to growth economies in Asia, and a large and growing quantum of investable funds, including through the superannuation system. The finance and insurance industries are a significant contributor to Australia's economy, accounting for 10.3% of Gross Value Added in 2012[1]. These industries are very competitive and the opportunity exists to build on Australia's strong domestic financial services industry to facilitate the export of financial services. Australia is currently a relatively minor player in the export of financial services, in part through policy and regulatory impediments that can be readily addressed.

We believe that competition, open and fair access, transparency and certainty in regulation and taxation should be hallmarks of Australia's financial system. In a world of fast moving technological change and increasingly mobile capital and talent, policy settings that facilitate a stable, efficient and competitive financial system will differentiate international financial centres. Financial capital and investment, as well as human capital, intellectual property and innovation, will be attracted to those centres that offer regulatory and taxation systems that are efficient and predictable, along with market depth, liquidity and stability.

The Inquiry should therefore examine areas of policy (and its administration) which can help develop Australia's financial system and, importantly, address the factors which impede its development as an international force.

[1] Australian Bureau of Statistics, ABS 5206. Gross Value Added is used to describe gross product by industry and by sector. It is defined as the value of output at basic prices minus the value of intermediate consumption at purchasers' prices. Use of basic prices for the value of output removes any distortion caused commodity taxes and subsidies across individual industries

Australian financial services businesses are subject to increasingly costly compliance requirements from regulators, exchanges, and taxation authorities, both in Australia and overseas. The Financial Crisis and subsequent events demonstrated the need for change in the nature and level of regulation and its oversight, though more so overseas than in Australia. However, there is now a real risk that the pendulum is swinging too far in the other direction, resulting in some excessive and unnecessary regulation, the costs of which will be ultimately borne by the community and in weaker economic growth.

The financial services industry offers the potential for innovations that can be of great benefit to the Australian community. Significant innovations include changes in banking and payments (e.g. internet banking, mobile banking and paywave) that have made for a more efficient and engaged consumer experience, and development of a broader range of investment products (e.g. cash management trusts, exchange traded funds, infrastructure as an investable asset class) that offer investors choice and better alignment with goals. Technology is rapidly shaping the development of financial services in Australia and globally. The speed of connectivity and device proliferation are influencing customer preferences in all industries, but particularly in financial services. Further innovation is thus an imperative if the industry is to be competitive internationally and it is incumbent on government and regulators to facilitate this while ensuring that risks are appropriately managed.

The Inquiry should therefore identify areas of unnecessary or excessive regulation and compliance requirements that divert resources from productive uses and result in Australia underperforming its potential. It should also review taxation settings that make this country less attractive for investment or constitute barriers to the export of Australian financial services. A particular challenge for the Inquiry will be to advise on policy settings that will facilitate innovative developments in the future that may not be anticipated today.

2. Making Australia internationally competitive in financial services

2.1 Developing Australia as a financial centre

Australia has the potential to be a global financial centre and government policies can facilitate this. This is consistent with key stated objectives of the Inquiry, including promoting domestic competition and international competitiveness, improving the availability of financial services, products and capital for all end users, assisting Australia in funding its growth, and promoting economic development and employment.

The Johnson Report

The Australian Financial Centre Forum, in its 2009 report *Australia as a Financial Centre – Building on our Strengths* (referred to as the Johnson Report) saw potential for Australia to become an international financial centre and made a number of recommendations to this end.

The report noted:

- The financial sector is at the core of the economic system, providing a range of services to households, businesses and governments. Economic research demonstrates a well-established causal link from financial sector development to economic growth. Having an open, efficient, well regulated and competitive financial sector is thus in the interests of all Australians.
- Countries with high quality financial sectors like Australia should be reaping the full benefits by exporting their financial services skills and experience to other countries
- Our financial sector ranks highly in international surveys on many of the key requirements for a successful financial centre. These include a highly skilled workforce and a first class regulatory framework that has served us well through the global financial crisis. Yet our exports and imports of financial services are low by international standards. Our funds management sector, one of the largest and most sophisticated in the world, manages only a small volume of funds sourced from offshore
- There are many reasons for this “inward focus”. Central amongst them are certain policy settings which inhibit a greater volume of cross-border financial transactions through Australia - a distinguishing feature of successful financial centres internationally.

A number of policy recommendations were made in the Report which could further improve the competitiveness and efficiency of our financial sector and boost our trade in financial services. Macquarie supports these findings and recommendations and notes that while progress has been made in certain areas, some key recommendations are yet to be implemented. Some of the more pressing issues and corresponding recommendations are summarised below.

Issue	Johnson report recommendation
Accessing offshore pools of savings	
Withholding tax on banks' offshore borrowings impedes access to offshore funding pools at competitive rates	Remove withholding tax on bank's offshore borrowings (Recommendation 3.4)
Lack of Islamic finance products in Australia is limiting our access to offshore savings pools	Ensure Islamic finance products have parity of tax treatment with conventional products (Recommendation 3.6)
Increase financial transactions channelled through Australia	
The Offshore Banking Unit ("OBU") regime is underutilised, due amongst other things to lack of recognition, various uncertainties in its administration and problems with the application process	Government should clarify support for and commitment to the OBU regime, remove tax uncertainty about the 'choice' principle and update the list of eligible OBU activities (Recommendation 3.2)
Other	
A more developed bond market would benefit Australia's economy and could assist Australia in playing a larger role in the region	Reduce regulatory requirements on corporate debt issuance to retail investors (Recommendation 4.6)
Lack of competition on exchange traded markets may potentially lead to higher trading costs and inhibit market development and innovation	Consider licences for new trading platforms and exchanges (Recommendation 4.5)
Policy initiatives focused on establishing Australia as a financial centre have not always been effectively implemented.	Establish a Financial Centre Task Force (Recommendation 6.3)
Under Australia's imputation system, franking credits are primarily of benefit to resident shareholders who can use them to offset their personal tax liability. Non-resident shareholders do not benefit (other than via reduced withholding tax). As franking credits must generally be uniformly allocated to all shareholders, franking credits paid to non-resident shareholders are essentially wasted	Further review by Treasury encouraged. However two proposals were put forward: • Australian companies be allowed to direct or stream unfranked foreign source income to non-resident shareholders and Australian-sourced (franked) income to resident shareholders; and • wholly owned Australian subsidiaries of foreign multinationals be allowed to stream franked dividends to Australian shareholders in the foreign parent, conditional on the foreign multinational being listed on an Australian stock exchange

Among these, some progress has been made on recommendations to attract overseas funds, specifically on the Investment Manager Regime, funds management vehicles, and the Asia Region Funds passport.

2.2 Export of financial services

Australia's strong domestic capability provides the potential to increase the export of financial services. The Inquiry should examine and make recommendations to remedy any impediments to the export of financial services, and the ability of Australia to attract a greater volume of cross border transactions.

2.2.1 Taxation

The tax system needs to generate revenue to meet government requirements in the most efficient and equitable manner possible. This means levels and structures of taxation that allow Australia to compete for internationally mobile capital and labour; transparency, and predictability of application, and efficiency and objectivity in administration.

Instead, Australia's tax provisions are becoming increasingly detailed, complex and hard to interpret, making it difficult for businesses to make good decisions and for the Australian Tax Office to administer the tax law. This creates a perception of risk in relation to conducting business in Australia and puts Australian businesses at a distinct competitive disadvantage internationally.

In addition to those issues raised in the Johnson report, there are a number of aspects of Australia's taxation policy and its application that inhibit the export of Australian financial services. These include:

- The controlled foreign companies regime, which in effect imposes Australian tax rates on Australian entities operating financial services businesses in most offshore countries (exceptions being the UK, USA. NZ, Germany, France, Japan and Canada). Coupled with the regime's increased compliance costs, Australian businesses are at a distinct competitive disadvantage against their non-resident competitors in these jurisdictions. This issue could be largely addressed by ensuring that financial services businesses, including lending and leasing activities, can be treated as active businesses.
- The application of outbound 'thin capitalisation' rules to non operating holding companies ("NOHC") and life companies held by ADIs is punitive and limits the ability to expand offshore. Under current ATO interpretation, the outbound thin capitalisation rules apply to NOHCs and life companies as though they were ADIs (which is inconsistent with their regulatory treatment). This requires additional capital to be held for tax purposes against Australian operations rather than deployed offshore. This issue should be rectified by aligning the thin capitalisation treatment of NOHCs and life companies held by ADIs with their regulatory treatment. Improved co-ordination between regulators (in this case, the ATO and APRA) would facilitate the resolving of such anomalous outcomes.

In relation to areas addressed in the Johnson Report, we make the following observations:

- **Offshore Banking Units**: Macquarie believes the OBU regime is an important component of facilitating the export of Australian financial services and supports the OBU related recommendations in the Johnson Report. In addition, the current OBU expense allocation rules are imprecise, overly complex and can deliver distorted outcomes. In particular, the rules that allocate indirect expenses against OBU income should be modified to operate on a fair and reasonable basis, in place of the complex and prescriptive rules currently in place.
- **Withholding tax:** As highlighted in the Johnson Report, the imposition of withholding tax for offshore borrowings by financial institutions is inconsistent with Australia's need to access a diverse range of funding sources. Macquarie considers that the discontinuation of the phased withdrawal of the withholding tax is unfortunate and that the rationale for abolishing this tax remains valid.

We note that the Henry Review[2] made a number of recommendations which, in addition to recommendations those in the Johnson Report, would facilitate development of Australia as a financial centre and increase investment activity in Australia:

- Reducing the corporate tax rate to 25% over the medium term. In this regard, we note that the corporate tax rate in Singapore is 17% and Hong Kong is 16.5%. The UK rate is currently 23%, dropping to 20% by 2015. Some jurisdictions, such as Singapore[3], provide additional concessions for financial sector companies. All Australian businesses, including financial services, will be disadvantaged by Australia's higher tax rate, however the fluidity of money will mean the impact on many elements of the finance sector may be profound.
- Encouraging savings through implementing a 40% discount for personal savings income in relation to interest, net residential rents and capital gains.
- The previous Government initially announced planned reductions in withholding tax in certain circumstances. However the May 2012 budget announced that the withholding tax on managed

[2] "Australia's future tax system" (chaired by Ken Henry), delivered in December 2009 and made 138 recommendations
[3] Inland Revenue Authority of Singapore, Budget 2013 Annex 8-A

investment trusts would be doubled from 7.5% to 15%. This means that the local funds management industry will no longer be on a level playing field with comparable jurisdictions in the Asian Region[4].

Finally, Australia's increasingly complex tax law is creating unnecessary uncertainty for taxpayers and tax administrators alike. In order to alleviate this, Macquarie supports the introduction of a statutory remedial power for the Commissioner of Taxation, which would provide the Commissioner with discretion to apply the law appropriately in circumstances where it is not operating as intended (either from a policy objective or compliance cost perspective).

2.2.2 Global regulation and competitiveness of Australian financial services

The rise in regulation is a global phenomenon. Consistency at the global level is therefore very important for Australian businesses that export financial services. Where a firm operates across jurisdictions, operational complexity can increase greatly, particularly where regulations are inconsistent. Many of the issues facing other countries are not applicable to (or as acute for) Australia. It is important, therefore, to ensure that overseas regulation is not simply imported into Australia where it is not necessary or fit for purpose. Getting the balance right between setting regulation that is appropriate for Australia and maintaining alignment with international regulatory developments will make a big difference to the competitiveness of our financial services industry.

The Reserve Bank of Australia has highlighted the challenges posed by global reforms across a diverse financial systems and regulatory approaches:[5]

> *The global reform process has been dominated by the north Atlantic countries most affected by the crisis. In effect, these countries are promoting a marked strengthening in their domestic regulatory approaches from the earlier approaches ... Some of the international reforms are addressing problems emanating from more market-based financial systems than those in other countries. Some flexibility to adapt reforms to national circumstances is needed, particularly for countries where financial systems came through the crisis in relatively better shape and regulatory settings proved more appropriate – such as Australia and much of Asia.*

The Inquiry should therefore consider approaches[6] that can build on Australia's strong regulatory framework to facilitate exports of financial services and avoid importing ill-suited regulation designed for other settings: such approaches include substituted compliance[7], mutual recognition and supervisory co-operation. We note in this respect the proactive role played by ASIC and APRA in achieving a positive substituted compliance determination for Australia with respect to the US CFTC. We would encourage broader application of this principle.

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[4] Henry David York, May 2012 "Federal budget – tax on managed trusts to double"

[5] Reserve Bank of Australia, *'G20 Financial Regulatory Reforms and Australia'*, Bulletin – September Quarter 2013

[6] See for example IOSCO proposed review of cross border regulation: http://www.iosco.org/news/pdf/IOSCONEWS273.pdf

[7] See for example, the December 2013 decision by the US CFTC to allow Australian swap dealers and major participants to comply with certain requirements from their own jurisdictions, instead of complying with certain CFTC rules

3. Regulation and its impact on competition, efficiency and innovation

As noted, regulation of financial institutions, particularly banking groups, is increasing – both in Australia and internationally. The effect is being felt across all levels of those organisations, with both positive and negative implications for the community.

Good regulation is clearly essential to a well functioning financial system. However, if not well designed and administered, regulation can come at a real cost, not just in terms of direct compliance activities and resourcing, but also in the diversion of management (and others within an organisation) from focussing on productivity improvements through innovation, to meeting regulatory requirements. The impact of this is borne by the community.

In a world of mobile capital and expanding choice of investment destinations, the cost of undue regulation in Australia will be movement of investment and innovation either outside the regulated sphere or to more efficient overseas financial centres. Neither of these outcomes is desirable for Australia. Even within the regulated sphere, undue regulation distorts investments decisions from what is optimal for customers as well as institutions.

The cost of regulation is generally diffused across a multitude of consumers and taxpayers. As this cost is often not directly visible or readily identifiable, this can lead to excessive regulation. There is no easy way of countering this bias. The ability of regulated entities themselves to argue the case is limited by the fact that, irrespective of the validity of their arguments, they will be perceived as self-serving.

This Inquiry is therefore timely, as we believe the balance between stability and efficiency can only be credibly re-examined in an independent and expert review. Comments by the Taskforce on Reducing the Regulatory Burden on Business (the 'Banks Review') in its 2006 report "Rethinking Regulation"[8], although made prior to the Financial Crisis, remain relevant today:

> "The relentless forces of globalisation mean that Australia needs to continue to drive reforms aimed at removing any impediments to efficiency and innovation. Underpinning a country's competitive success internationally is the effectiveness of its domestic regulatory structures. Good regulation can enhance Australia's ability to compete and prosper economically; inappropriate or costly regulation will handicap our performance. Like many other developed countries, Australia has undergone a relatively rapid rise in regulation over the past couple of decades, in response to a succession of social, environmental and economic needs and pressures. In our view, business is justified in protesting at the compliance and other burdens that this regulatory inflation has entailed."

3.1 Impact of increasing regulation

Over recent years, there has been significant growth in the volume and reach of regulation, resulting in greater complexity and compliance costs. This is occurring globally. While there has been greater co-ordination among regulators, there are differences in context and approach, resulting in regulation that is not always consistent. This in turn is leading to further compliance costs for Australian businesses that export financial services.

[8] Foreword to the Report

- Between 1936 and 1975, Australian income tax law grew by six times its original length to 526 pages, and subsequently by more than 10 times to 5,743 pages in 2008[9].
- Basel I, adopted in 1988, was 30 pages long and relied on simple arithmetic. In the case of Basel III, finalised standards, guidelines and practice documents issued to date (excluding superseded documents) amount to 482 pages, and involve complex mathematical calculations, with additional consultative documents that are yet to be finalised. It is estimated that implementing Basel III in Europe will require 70,000 full time employees.
- Once completed, reforms under the US Dodd Frank Act might run to 30,000 pages of regulations and also necessitate tens of thousands of employees[10].

One of the key challenges for financial services firms globally is the implementation of changing regulatory requirements and dealing with shifting supervisory expectations. Industry surveys[11] indicate that global compliance officers expect compliance requirements to increase further as regulation continues to change and grow, resulting in greater costs and diversion of effort across all levels of the organisation, including management and Board. Thomson Reuters statistics show a 52% rise in the number of regulatory alerts[12] in 2013 (to 26,950) issued by the 400 regulators and exchanges that they track. This is indicative of the continuing release of the detailed regulation that support legislation issued in previous years, in addition to new reform.

As an example, only half of the US rules necessary to implement Dodd Frank have been finalised – and Macquarie's compliance costs to date in relation to OTC Reforms are estimated at A$28 million and expected to exceed A$50 million when completed.

For 2014, Macquarie is seeing a continuing increase in regulatory initiatives and examinations, regulatory information requests and enforcement actions. The resources allocated to compliance have increased greatly and the costs continue to rise. For example:

- Macquarie is currently regulated by 190 authorities across 28 jurisdictions.
- We estimate that the cost to Macquarie of addressing regulatory change and meeting compliance requirements has tripled over the last three years to more than $300 million per annum. In addition, there is the cost to the organisation resulting from the diversion of management time.
- Macquarie is experiencing increased interactions with key regulators. The intensity has increased across all jurisdictions, including in Australia. For example, the number of routine regulatory inspections experienced by Macquarie in the half year to December 2013 was about double what it was for the entire financial year to 2011.

A surge of information requests

Requests for information from ADIs and other market participants by regulators, often acting independently of each other, have been rapidly increasing. The requests do not always involve an understanding of the cost or capabilities required to produce that information. There appears to be a presumption that more information is better. However, the purpose of the request and the utility of what has to be provided is not always clear to participants. In some cases, the information is unlikely to be utilised in any meaningful way, if it is utilised at all. Moreover, such information is being sought around the world, yet there remain significant legal barriers to making it widely available.

To give just one example, as part of the impact of the OTC Reform outlined in the G20 leaders summit in Pittsburgh in 2009, Macquarie estimates that its costs so far in transaction reporting on

[9] Australian Treasury 2008, Architecture of Australia's tax and transfer system, Department of the Treasury, Canberra
[10] Speech by Andrew Haldane, member of the Financial Policy Committee at the Bank of England, "Turning the tide of red tape" April 2013
[11] Thomson Reuters Accelus, Cost of Compliance Survey 2014. Thomson Reuters' annual global Cost of Compliance survey provides insight into the experiences and expectations of the compliance function. Over 600 practitioners across 71 countries participated in the 2014 survey
[12] Regulatory alerts includes press releases, new rules, consultations etc from regulators that are collated and tracked by Thomson Reuters

OTC derivatives to global regulators in the United States, Europe and Australia is in the order of A$15 million. The disclosure of this information has been made difficult by laws on privacy, data protection and bank secrecy, which has been recognised by the OTC Derivatives Regulators Group (of which APRA, ASIC and the Reserve Bank are members).

While there is clearly a need for regulators to access market information from enterprises when developing or analysing regulation, this comes at a cost which needs to be taken properly into account. Particularly in the global context, consideration should be given to standardising and streamlining the collection of information, and to clarifying who is entitled to what information, in what time frame and for what purpose. This will require a greater degree of co-ordination among regulatory agencies in identifying data that is truly necessary, given the costs involved, and delineating responsibility for its collection and dissemination. (This issue has become a focus for attention by the Regulatory Policy Committee of the OECD.)

3.1.1 Board Governance

The increase in regulatory requirements is one thing; an expectation by regulators that a company's board will 'ensure' compliance is another, raising issues not only related to cost, but also to effective corporate governance itself.

As the regulatory requirements for board assurance have increased, the volume of board reporting and due diligence required to effectively meet this obligation have risen greatly. For instance, in the six years from FY2008 to FY2014, the amount of time spent by directors at committee meetings dealing with regulatory and compliance matters (Risk, Audit, and Governance and Compliance Committees) has increased by over 50 per cent.

Compounding this trend has been a marked increase in the breadth and depth of regulatory changes that impact on day to day operations requiring involvement of the board. This is especially the case for any entity under the supervision of the Australian Prudential Regulation Authority (APRA), with an ongoing accumulation of governance measures[13] for banks, and general and life insurance companies increasing the role and responsibilities of boards.

This places a rising burden on boards, but it also has the potential to blur the well established division of responsibility between the board and management. Practically, it also means that the time and input available from Board members, both within and outside meetings, is disproportionately spent on compliance matters as opposed to market strategy and meeting customer needs. To the extent that, in response to such pressures, boards of ADIs are obliged to become comprised mainly of financial services compliance experts, the loss of diversification on Boards could be felt in innovation or strategic direction with negative outcomes for the financial services industry and the economy generally.

This is not to dispute that there was a need for an increased regulatory focus on risk, particularly systemic risk, in light of the experience of the Global Financial Crisis. However, the fact remains that Australian financial services institutions were better placed than many of their counterparts in other countries and generally came through the events of the Financial Crisis relatively well.

3.1.2 Client Money

The protection of client money is fundamental to the effective operation of the financial system, not least for investor confidence. There has been a renewed focus on client assets internationally, and it is timely to review the rules as they are being applied in Australia. It is particularly important in this area to have rules that are clear, well targeted and simple to implement.

[13] The new measures include Prudential Standard CPS 220 Risk Management (Standard), which will commence on 1 January 2015, and Draft Prudential Practice Guide CPG 220 – Risk Management (Draft Guide)

The reality is that client money laws in Australia currently lack precision and are difficult to apply, resulting in ambiguity (for all participants) and significant legal, compliance and operational costs. The difficulty in interpretation and specific application of rules can result in differing treatment of client money by different industry participants, an often confusing result for clients. Current legislation applies to all AFSL holders in the same way, irrespective of their activities, and accordingly does not pay regard to significant differences between brokers, product issuers and custodians.

The additional transaction costs resulting from this uncertainty will ultimately flow through the Australian industry and impact adversely on the interests of clients themselves.

We note work done in this area by the Commonwealth Treasury, including the 2011 discussion paper "Handling and use of client money in relation to over-the-counter derivatives transactions", and by ASIC, including its 2012 "Review of client money handling practices in the retail OTC derivatives sector". We believe more is needed to provide the necessary clarity and certainty for all participants, and would be willing to work with Treasury and ASIC to this end.

3.2 Regulation beyond required international standards: the effect on competition and competitiveness

3.2.1 Basel III and APRA's "super equivalence"

Good prudential regulation is essential for the safe and effective functioning of Australia's banking system. The Basel III reforms have emerged from reviews of global bank capital requirements undertaken at an international level. APRA has essentially imported these reforms into Australia without amendment. Many of the reforms under Basel III were motivated by circumstances overseas that did not occur in Australia. Further, under its "super equivalence" approach, APRA has overlaid additional requirements on Australian ADIs over and above even the Basel III requirements. Indeed, the Basel Committee on Banking Supervision recently identified 27 areas where APRA's rules are stricter than the Basel standards require ("Regulatory Consistency Assessment Programme (RCAP) - Assessment of Basel III regulations – Australia", March 2014, p54).

One important such area of 'conservatism' is in the calculation of minimum capital adequacy requirements. The RCAP report stated:

> The simple reality is that, because of APRA's conservative approach, an internationally active ADI in Australia can face a capital requirement that is at least 100 basis points higher than that facing any other international bank subject to the minimum requirements of the Basel Framework. (p5)

We estimate the effect of this additional conservatism has been to increase the reported minimum capital requirements for Macquarie and the four major domestic banks by about 21% over and above global "harmonised" Basel III requirements. This is equivalent to about A$29bn of additional common equity tier one capital[14] for these banks.

These differences in capital requirements arguably place Australian ADIs at a competitive disadvantage relative to their international competitors in the global market for debt capital, increasing the cost of funding to the Australian community and impacting global competitiveness. That said, the ability of Australian banks to disclose their "harmonised" Basel III requirements goes some way to lessening this disadvantage.

[14] Macquarie CET1 ratios and $ capital impact of super-equivalence taken from internal Dec13 data, CET1 ratios for other banks obtained from latest Full-Year results presentations available (CBA:Dec13, WBC,NAB,ANZ:Sep13), Pillar 3 regulatory disclosures at the same dates as above were used to calculate the $ capital impact of super-equivalence.

3.2.2 APRA's proposed "Conglomerates" framework and the impact on ADI fund managers

APRA's proposed framework for the supervision of conglomerate groups ("Conglomerates regulation") would impose additional capital requirements on ADI-owned fund managers that do not apply to other local managers, foreign-owned local fund managers or, importantly, managers of funds overseas. This results in differences in the competitive position of fund managers within Australia and internationally (e.g. in competing overseas with large global fund managers). This could result in funds management businesses and Australian sourced capital moving toward managers that are not subject to these requirements and can as a result provide fund management services at a lower cost. Further, it impedes the ability of the regulated entities to expand funds management activities overseas.

Regulation of ADI-owned fund managers

Under the proposed Conglomerates regulation, fund managers that are part of a banking conglomerate will be subject to more stringent capital requirements in comparison to global fund managers and domestic non ADI owned managers in regard to management of the same products. These include:

- Imposition of an additional capital requirement based on the amount of funds under management (FUM charge) to cover operational risk. The requirement is based on a fixed charge, irrespective of risk; it is calculated differently to APRA's requirements for all other operational risks in the group and is higher than the charges for other operational risks. The fixed charge incorrectly assumes that all products contain equal operational risk. For example lower margin fixed income products carry lower operational risk than most other products. This additional capital requirement will, among other things, make it difficult for ADI owned managers to offer lower margin products. This includes higher credit debt products that may be attractive to super funds and supportive of Australia's future growth. The application of operational risk capital models would more accurately reflect the operational risk levels of different products. In this regard, we note that ADI owned managers already allocate operational risk capital to fund management activities based on the risks involved and that this is regularly reviewed

- The capital treatment of the purchase price for funds management businesses (goodwill and intangibles will require 100% equity backing) places ADI owned managers at a disadvantage relative to foreign managers and non ADI owned domestic managers when seeking to make acquisitions of local or overseas asset management businesses. Other managers typically fund acquisitions with a mixture of debt and equity – managers in an ADI conglomerate group are prohibited from doing this, even with very modest levels of debt. This inhibits the ability of ADI owned managers to expand through acquisition or acquire new areas of expertise and also limits their ability to compete with larger international fund managers as well as other domestic non-ADI owned managers.

The importance of depositor protection is not in question. Rather, the issue is whether the proposed regulations balance the need for protection appropriately with the effects on competition and efficiency that are also in depositor's interests. Conglomerate groups already hold sufficient capital against funds management activities, including for operational risk. In addition:

- Funds management businesses add strength and diversity to the regulated institutions within conglomerate groups and to Australia's financial system overall, particularly in light of their stable annuity style earnings
- The proposed rules go beyond comparable international requirements and will distort the allocation of capital by conglomerate financial groups away from funds management

- The risk that an ADI conglomerate will have legal liability because of the activities of an asset manager subsidiary is very low
- These proposed rules disadvantage Australian ADI conglomerate groups operating funds management businesses in Australia, limit their ability to bring innovative products efficiently to the market, and inhibit the export of financial services by these groups internationally

The regulatory burden on ADI-owned asset managers would increase their costs (which are then either passed on to investors or reduce the returns of the asset manager to its ADI parent) and will reduce the resources available to produce innovative products both in the Australian market and offshore.

Macquarie therefore submits that APRA's proposed requirements would be detrimental to the Australian funds management industry and should not proceed. Conglomerate groups already hold sufficient capital against funds management activities.

3.3 Accounting for impacts on market efficiency and competitiveness in regulation-making

In its report, *Rethinking Regulation*, the Banks Taskforce noted

> "A common theme in submissions was a belief that APRA and ASIC, and to some extent policy-makers, are overly risk-averse. Despite policy intentions to the contrary, this is seen as having led to a prescriptive and rigid approach to regulation aimed at eliminating risks. There was also concern that such a risk-averse culture contributes to enforcement action that may be disproportionate to the risks involved...
>
> Government must provide guidance to regulatory agencies on its expectations in carrying out their functions. In particular, it should provide specific guidance to APRA and ASIC about what it expects of them in achieving an appropriate balance between achieving safety and investor protection and market efficiency, consistent with their statutory responsibilities" (p123)

These observations remain relevant to current circumstances. Indeed APRA's focus on ensuring stability through a prudential lens directed at individual firms, relative to market or competitive effects on the development of the financial system, has become more pronounced. This contrasts with the approach of some other effective regulators internationally. For example, the Monetary Authority of Singapore is tasked with both prudential regulation and developing Singapore as a financial centre.

> "As Singapore's central bank, the Monetary Authority of Singapore (MAS) promotes sustained, non-inflationary economic growth … MAS is also an integrated supervisor overseeing all financial institutions in Singapore -- banks, insurers, capital market intermediaries, financial advisors, and the stock exchange. With its mandate to foster a sound and progressive financial services sector in Singapore, MAS also helps shape Singapore's financial industry by promoting a strong corporate governance framework and close adherence to international accounting standards. In addition, it spearheads retail investor education. MAS ensures that Singapore's financial industry remains vibrant, dynamic and competitive by working closely with other government agencies and financial institutions to develop and promote Singapore as a regional and international financial centre"[15]

[15] From MAS website

In February 2007, the then Treasurer issued a Statement of Expectations to APRA in response to matters raised in the Banks Report and also the Uhrig Report[16]. We are not aware of any subsequent refresh or update of the Statement of Expectations. The Inquiry should consider a requirement for periodic updates to ensure the government's broad policy objectives can support the regulator's achieving an appropriate balance between risk mitigation and efficiency enhancement.

3.4 Importance of predictability

Stability in and predictability of regulation are important to the effective operation of the financial system and to engender confidence. Financial institutions operate in inherently uncertain markets – dealing with these requires ongoing risk management; but regulatory uncertainty imposes additional complexity, compounding market uncertainties and making the management task more difficult. Reducing regulatory uncertainty can enable more efficient decision-making and benefit the wider economy.

There are a number of recent instances of changes (or announced changes) to rules or regulation that have subsequently been reversed (or where an intention to reverse has been announced). These include, but are not limited to, the Resource Super Profit Tax and Minerals Resource Rent Tax, fringe benefits in relation to employer-provided cars, withholding tax for offshore borrowings of financial institutions, taxation of shares and rights acquired under employee share schemes, and the Clean Energy Act 2011. We note the changes to withholding tax run contrary to recommendations made in both the Johnson and Henry reviews. In addition, there are numerous examples related to superannuation[17] where the stability of regulatory settings is particularly important. Superannuation is effectively an investment for life, and short term changes to the rules undermine confidence as well as the ability of Australians to plan for the future.

The Inquiry will need to examine, therefore, how to bring about the degree of certainty required to sustain confidence in the system as a whole.

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[16] Review of Corporate Governance of Statutory Authorities and Office Holder, June 2003

[17] Some examples include the following: a) The proposal on 5 April 2013 by the Government to tax annual earnings on certain superannuation pension accounts in excess of the first $100,000 was to be a reversal of the long held retirement income policy setting affording tax exemption on pension account earnings. In recent months the current Government has announced that this proposal has been discontinued; b) The caps on tax-advantaged contributions have traditionally been steadily indexed over time, but since 2007 these caps and their indexation has chopped and changed, in part due to short term fiscal considerations; c) The relatively recently legislated schedule for escalation of Super Guarantee contribution rates from 9 to 12% of salary, along with the recent introduction of the Low Income Superannuation Contribution are proposed to be adjusted or reversed as part of the Government's legislative package relating to the repeal of the mineral resources tax.

4. Funding Australia’s growth

In this section we comment on some aspects of Australia’s funding landscape that can improve Australia’s ability to fund future growth: the scale of funds invested through Australia’s superannuation system, the (relatively) undeveloped domestic corporate bond markets, securitisation, and hybrid capital instruments. Australia’s position as a capital importer means offshore borrowing must remain a key feature of the financial system with any risks associated with this activity being well managed. Development of Australia as a global financial centre will increase available funding options.

4.1 Superannuation savings

Australian superannuation assets have grown by 12% p.a. since 1996 to reach $1.8 trillion as at December 2013[18], making Australia the fourth largest pension market in the world[19]. Superannuation funds are expected to grow to $3 trillion by 2020 and to $5.5 trillion by 2030 and their assets may well exceed bank financial assets in years to come[20].

The pool of superannuation assets is expected to grow faster than the overall economy, and decisions about how this is invested will play an important part in shaping the economy. As the size of the funds managed through superannuation grows, managers are likely to expand the range of their activities and, with appropriate incentives, broaden their investment universe. Funds having long-dated obligations to their contributors have reason to match these with long-dated investments. As the population ages, there will be a greater need for annuity income products to support retirement. These developments can align with Australia’s need to fund future growth. It is therefore important to have appropriate policy settings and investment incentives to allow this pool of superannuation saving to fund Australia’s growth. The trade-off between regulation and access to new products and markets needs to be made such as to ensure that this can occur in an efficient manner.

Demand from superannuation funds for Australian assets should be met by an increase in the supply of suitable assets in which funds can invest. Asset classes that could benefit from tapping the large pool of saving in superannuation include:

- Infrastructure, where there will be a need for more and longer dated investment; and
- Corporate bonds and other fixed income products, which can provide annuity income to support an ageing population.

Policy settings need to be examined to ensure there are no features that unduly discourage development of these asset classes. The Inquiry presents a useful opportunity to assess whether the regulatory framework for superannuation is meeting the objectives behind its introduction – involving concessions to enable tax payer funded benefits plus investment accumulation and returns to reduce reliance on government pension and ensure an adequate standard of living for older Australians.

[18] APRA, Quarterly Superannuation Performance December 2013 (interim edition issued 20 February 2014)

[19] Towers Watson, Global Pension Assets Study 2014

[20] For example, if bank assets grow in line with national income at 5.2 per cent per year while superannuation assets grow at 7 per cent per year, it would take 40 years for the superannuation pool to be equal to the stock of banking assets - see “Superannuation asset allocations and growth projections” 17 February 2014 by Professor Rodney Maddock

A strong and competitive funds management industry

A strong, innovative and competitive Australian funds management industry will support the growth in superannuation, drive innovation and provide a range of products. In addition, Australia's fund management industry has the potential to attract a higher level of overseas funds for investment in Australia.

At present, there is a relatively low level of foreign sourced funds being managed in Australia. Australia's funds industry had $2.3tn of funds under management ("FUM") at 31 December 2013[21]. Of this $1.5tn (65%) of FUM is managed by resident investment managers and 0.8tn of FUM (35%) was placed with non-resident investment managers (including Australian fund managers with entities based overseas). Importantly, of the $1.5tn managed by Australian resident fund managers, only $0.08tn (5%) of that amount was directly managed on behalf of overseas investors, a level that is low in comparison to major regional centres such as Hong Kong[22] and Singapore[23]. Two thirds of FUM in Hong Kong and 80% of funds managed by resident mangers in Singapore is sourced from overseas investors.

	Australia	**Hong Kong** (fund mgmt total)	**Hong Kong** (asset mgmt only)	**Singapore**
As at	Dec-13	Dec-12	Dec-12	Dec-12
Currency	AUD 'b	HKD 'b	HKD 'b	SGD 'b
With resident investment managers	1,492	*n/a*	5,707	1,626
From resident investors	*95%*	*n/a*	*n/a*	*20%*
From overseas investors	*5%*	*n/a*	*n/a*	*80%*
With overseas investment managers	805	*n/a*	2,539	*n/a*
Total funds management industry	2,287	12,413	8,246	*n/a*
From resident investors	*n/a*	*35%*	*n/a*	*n/a*
From overseas investors	*n/a*	*65%*	*n/a*	*n/a*

Policy settings should facilitate, and at a minimum not impede, management of overseas funds in Australia (as well as the expansion of Australian fund managers into overseas locations). In this regard we note the recommendations of the Johnson Report on the investment manager regime, funds management vehicles and Asian passport schemes (and that there has been progress in some of these areas), as well as recommendations supporting and clarifying the operation of the overseas banking unit (OBU) – see section 2.1. It is crucial that consideration be given in this inquiry to the removal of the impediments in our tax system to foreign capital being invested with Australian managers.

Another element of encouraging Australian fund managers into overseas locations is maintaining the currency of Australia's tax treaties. For example, Australia's double tax treaty with China was last negotiated in the 1980's when that country was a very different place. As a result, Australian fund managers are at a disadvantage compared to managers in jurisdictions with recently negotiated treaties - who enjoy relief from Chinese capital gains tax on Chinese share portfolio investments unavailable under the Australia / China tax treaty.

Review of regulations that may impede development of broader superannuation investment

There have been sound policy developments in recent years offering investors greater choice or access to lower fee products. We support the policy objectives behind these. However, over time, there could be some

[21] Australian Bureau of Statistics, ABS 5655.0 December 2013
[22] Securities and Futures Commission of Hong Kong, Fund Management Activities Survey 2012
[23] Monetary Authority of Singapore, 2012 Singapore Asset Management Industry Survey

unintended consequences that may impede the objective of broadening investments. In this context, the Inquiry should examine:

- MySuper – which potentially carries the risk of increased correlation of investment and systemic risks through large scale movement to (lower fee) commoditised products. Lower cost investments do not necessarily ensure lower investment risk, as significant market risk (beta) remains. Rapid responses to sudden market movements are also less assured in a low cost fund to the extent that this means less active management. That said, we support the principles behind MySuper and believe these risks can be addressed through development and innovation in the industry which should see a broader range of product offered in a cost effective way.

- portability in super, or the ability of investors to switch investment strategies, allows choice and flexibility, which are both desirable, but can at the same time create disincentives for fund managers to invest in long term assets that are less liquid. Again, while we support the principle of portability, any concomitant disincentive to invest in assets like infrastructure (which normally should be a good match for long dated liabilities in superannuation) needs to be examined.

4.2 Developing a domestic corporate bond market

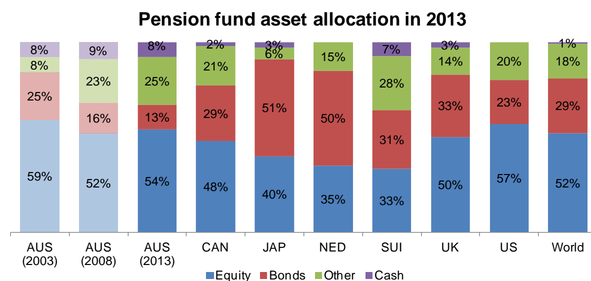
Australia's corporate bond market is small by international standards with domestic non financial bonds outstanding of $51bn as at November 2013, and a further $180bn issued offshore by Australian corporates. The size of 'Kangaroo' issuance (the term for issuance by non Australian organisations into domestic bond markets) in 2013 ($7.3bn) is similar to that issued by Australian corporates locally ($8.5bn) indicating the existence of an appetite for debt from issuers outside the financial sector[24].

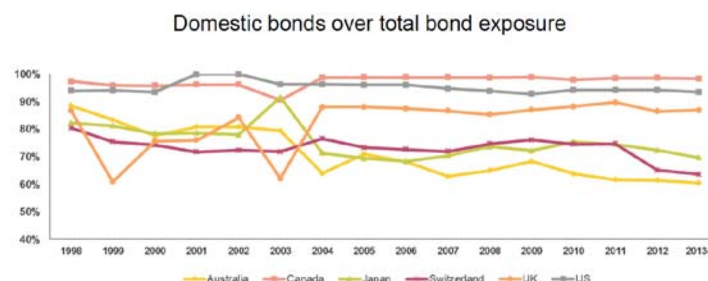
A deeper and more liquid domestic corporate bond market offers a number of benefits for the financial system. It would provide both Australian banks and non-financial corporates with additional and diversified funding sources, as well as the ability to issue longer maturity debt. It would provide investors with a greater opportunity to diversify their investment portfolios by maturity, type of investment (traditionally equity-heavy portfolios of fund and superannuation managers could be balanced by some fixed income allocations) and issuers (fixed income investments currently held by fund managers are disproportionately issued by financial institutions).

A stronger domestic bond market would also help ensure that investment capital remains in Australia rather than being invested in offshore bond markets, although we would expect that investment managers would continue to seek offshore exposure as part of a diversified portfolio. The key would be to offer attractive investments domestically that attract local and foreign capital.

In Australia, there is currently a relatively low allocation of assets under management in the form of fixed income products. Indeed, the allocation to fixed income assets by Australian superannuation funds has reduced over time, is significantly lower than other major pension jurisdictions, and that the level of investment in domestic bonds is low and has reduced over time. Domestic issuance is mainly investment grade[25], possibly limiting the pool of issuers domestically.

[24] See for example research paper by Credit Suisse "Commercial Banks – Structural Balance Sheet Shift" 30 January 2014 pp7-9
[25] See for example research paper by Credit Suisse "Commercial Banks – Structural Balance Sheet Shift" 30 January 2014 pp9-10





Source: Towers Watson, Global Pension Assets Study 2014

In assessing ways to increase participation in the corporate bond market, the Inquiry will need to look at factors that may inhibit growth in the market, including:

- Competing financial instruments available to investors – these include bank deposits (with relatively high interest rates and subject to government guarantees for retail investors), equities (potentially providing higher returns including capital gains, and tax advantaged through franking credits), and hybrid capital instruments (which may also carry some franking credits). The lack of tax advantage for bonds is a limiting factor in generating retail interest.
- The high cost of issuance of corporate debt (documentation and other issuance related costs, as well as liability on directors necessitating management and Board time), which require high volume of issuance to justify. In this regard, we recommend the adoption of *Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2013*.

Macquarie draws attention to the recommendation in the Johnson Report regarding development of the corporate bond market and the reduction in regulation to facilitate access to retail investors (see section 2.1). We believe this will assist in the development of the market but note that there may need to be a greater level of institutional participation. We note that in the US, retail investors are a small component of the overall corporate bond market, with the majority of corporate bonds held by institutions (pension industry, mutual funds and financial institutions).

To develop a broader and deeper corporate bond market, a greater level of participation by government may be needed. For example, this could require issuance of more debt and a greater variety of maturities to provide appropriate benchmarks for the market, issuing debt (either alone or with private sector participants) to fund projects with social and/or economic benefits, or investing in private debt (e.g. of corporate issuers) to develop issuance programs[26]. In regard to the latter, we note the role played by the Australian Office of Financial Management in the securitisation market. A similar role may be required to facilitate development of the corporate bond market.

4.3 Securitisation

A number of parties are expected to make submissions relating to the securitisation market and we therefore make limited comment. It is important to emphasise, however, the important role that securitised markets play in Australia's financial system, particularly enhancing competition in residential mortgage lending.

In offshore financial markets, notably the United States, Europe and parts of Asia, more developed securitised markets benefit a much broader range of economic activities including consumer and SME motor vehicle & equipment finance, financing of public utilities and infrastructure assets, corporate loans, student loans and credit cards. Initiatives to increase the breadth and depth of the investor base for high quality Australian securitised product will further develop these markets. For example, increased investment allocation to fixed income products in general, the removal of withholding tax, and more co-ordinated global central bank repo eligibility (for example, with overseas central banks reciprocating existing RBA repo

[26] See discussion in PWC paper "Sustainably funding Australia's prosperity" commissioned for the Australian Bankers' Association, February 2014, section 5.2.1

eligibility for kangaroo issuers) will benefit Australian issuers of securitised debt and the development of Australia's securitised markets.

4.4 Offshore borrowing

We note the reference in the initial media release for the Inquiry[27] to minimising "exposure to volatility in global capital markets". For global institutions like Macquarie with assets across a number of countries, borrowing in the currency of the assets outside Australia (in particular to fund assets in the same currency) is a sound and necessary practice. Wholesale funding of term assets (i.e. with term liabilities) is desirable in many situations, provided appropriate liquidity management is in place.

Asia represents a large and growing pool of the world's savings and is therefore a key potential source to help fund Australia's growth. In this regard, two recommendations in the Johnson Report would facilitate offshore issuance (see section 2.1):

- Removal of interest withholding tax for financial institutions; and
- Support and clarification of the operation of the OBU

4.5 Taxation treatment of capital instruments

Capital instruments form an essential part of a bank's capital structure and we believe rapid, competitive access to markets is essential for a robust banking system. There are a number of outstanding tax issues impacting capital issuance for Australian banks. Finalising the taxation treatment of capital instruments can be prolonged and resource intensive, and uncertainty often remains even after issuance. Simplified issuance of bank capital instruments without giving rise to complicated taxation issues is in the interests of all issuers, APRA and the ATO. Major issues outstanding include:

Offshore Additional Tier 1 (hybrid) capital issuance and section 215-10 of the Tax Act

A significant and increasing number of overseas jurisdictions are now treating hybrid capital instruments as deductible for taxation purposes, which puts Australian banks attaching franking credits to hybrid distributions at a competitive disadvantage. These jurisdictions currently include the United Kingdom, Denmark, France, Netherlands, Italy, Spain, Sweden and Singapore.

Section 215-10 was intended to address this disadvantage by allowing foreign branches of Australian banks to issue hybrid capital on an even footing with foreign competitors. The concession was originally introduced in 2001 and allowed hybrid instruments issued at or through offshore permanent establishments to be unfrankable. The explanatory memorandum for this provision commented:

> *Aligning the taxation treatment of foreign branches with that of foreign subsidiaries of the ADI and foreign independent entities in relation to the issue of eligible hybrids will assist Australian ADIs to grow their businesses conducted through foreign branches.*

However, there is an inconsistency between this principle and the application of the law by the ATO. Indeed, Macquarie's recent experience is that under the current approach this provision has been rendered unworkable. This affects the ability of Australian banks to access offshore hybrid capital efficiently – given the time taken to obtain an agreed position with the ATO and the ultimate cost of the capital instrument. To our knowledge, in recent years, no Australian bank has issued a hybrid capital instrument in foreign markets and successfully relied on section 215-10.

[27] Media release by Tony Abbott and Joe Hockey 20 November 2013

Non-viability write-down provisions and tax impacts

The Basel III capital rules require all capital instruments to be subject to non-viability provisions, whereby they are either converted to ordinary shares or written off should the bank be deemed to be non-viable, or require a public sector injection of capital. In the situation where a write-down occurs, the gain from this write down is potentially taxable. APRA has determined that where taxable income would arise, the capital benefit of the instrument is reduced, reflecting the tax. As such Australian issuers would require 30% more capital for a "write-down" capital instrument than would a comparable offshore issuer. This issue has limited the ability of Australian banks to access offshore Tier 2 markets efficiently. It is our understanding that APRA, the ATO and Treasury are all aware of this problem, but more than 2 years have now passed since it was raised without any result.

5. Technology and Innovation

5.1 The importance of technology and innovation

Technology is shaping the development of financial services globally. Disruptive technologies are key drivers of productivity and benefits to users. This can be expected to increase further in coming years, as argued in a Deloitte White Paper[28]. This has the potential to deliver benefits to Australians by way of increased choice, competition and convenience, as well as lower costs.

As an example, the speed of connectivity and mobile / tablet device proliferation are shaping customer preferences in all industries, including financial services. This is particularly true in Australia, where the rollout of 4G mobile networks and the high penetration of smartphones (65%[29]) are having a significant influence on consumer behaviour and services such as mobile banking and wealth management applications.

Policies that facilitate innovation will result in benefits for the community. Removing unnecessary or excessive regulation will free up resources that can be deployed toward development and innovation. However, developments in technology (and its use) need to be monitored to ensure Australian consumers remain protected and the financial system remains sound.

We believe the Government and regulators have an important role to play in facilitating innovation to meet evolving customer needs, while ensuring that risks are appropriately managed. We note three key areas of technology and market innovation where the Government and regulators have a role to play:

1. Evolving customer preferences for consumption of financial services;
2. The use of new technologies in financial services; and
3. The entry of “non-traditional” participants in financial services.

5.2 Evolving customer preferences

With customers increasingly procuring products and services online or via mobile devices, we would encourage an examination of existing legislation to ensure financial services may be delivered effectively through digital channels.

There has been strong adoption of online and mobile banking services by customers. While the legislative and voluntary code framework acknowledges that material may be sent electronically, it stops short of recognising that most regulated disclosures are available for customers to download electronically at any time. We would welcome a review of disclosure obligations and associated provisions to ensure that regulations adopt a technology-neutral approach while providing consumers with sufficient protection[30].

We also recognize that customers may increasingly want to obtain more financial services online. Apart from online and mobile banking platforms, social media platforms and mobile application stores may also evolve into platforms for procurement of financial advice, financial products such as loans and insurance and transactional services. Currently, legislation does not impede the development or deployment of such services. While we are therefore not recommending any changes, we encourage monitoring of these developments to ensure that Australian consumers remain protected and appropriate oversight is maintained.

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[28] Deloitte, “Digital Disruption: Short Fuse, Big Bang”

[29] “Google: Our Mobile Planet”, May 2013

[30] We remain committed to serving customers who have a preference for paper-based communication.

5.3 The use of new technologies

Adoption of new technologies will drive benefits for the industry, customers and ultimately the community.

For one thing, there are many potential opportunities to drive standardisation across the industry which would in turn allow Australian organisations to reduce the cost of maintaining base services / standard technology capabilities and direct funds towards innovation in the areas of competitive differentiation. These opportunities need to be explored as they could provide increased competitive advantage both domestically and globally.

The cost of maintaining technology infrastructure is large. With growing demand for 24/7 services, online and mobile banking, and enhanced security and risk management, Macquarie spends millions of dollars each year in upgrading and refreshing technology systems. This is of course not unique to Macquarie, with Australian banks estimated to have spent over $19 billion on technology in the last 5 years[31].

One opportunity to improve quality and reduce cost is to move to cloud-based technology infrastructure. This would afford scale, flexibility and greater security, with the ability to rapidly update services with enhanced safeguards. Given the paramount importance of security when transitioning to new technologies, regulators need to monitor the implementation of such changes. As APRA creates guidelines for the use of cloud computing by financial services companies, we would encourage a principles-based approach rather than prescribed guidelines – this would enable banks to take advantage of cloud computing technologies and innovations, while adhering to the principles of security and customer service in particular.

We also recognise that identification and authentication protocols are rapidly changing globally. The FIDO (Fast Identity Online) Alliance, which includes businesses such as Mastercard, Bank of America, Microsoft and Google, is committed to "developing specifications that define an open, scalable and interoperable set of mechanisms that supplant reliance on passwords to securely authenticate users of online services"[32]. These mechanisms may soon become the norm, delivering greater convenience to consumers. Regulation should accommodate such innovations. At the same time, their implementation should be monitored to ensure security and reliability.

The need for innovation must, of course, be balanced with appropriate risk management. For example, there is likely to be an increase in technology implemented through or supported by third party providers (e.g. cloud based infrastructure services, Platform as a Service, Software as a service, Business Process Outsourcing). On a system-wide basis, there needs to be an understanding of the impact of increased reliance on third party providers. This is particularly so for the Australian market, where due to the relatively small market (at least in a global context) there may be additional concentration risk given the small number of providers.

5.4 "Non-traditional" new entrants

The last decade has seen a variety of new entrants in financial services globally, including in:

- **Alternative Online Banking -** Online banking and transacting offers that are positioned as alternatives to traditional banks;
- **Scaled Wealth Advice -** Scaled advice offers provided direct to customers through an online medium;
- **Investment platforms -** Alternative platforms and tools for investing in security markets;
- **Personal Financial Management -** Platforms that consolidate personal financial information for budgeting and portfolio management;
- **Peer to Peer Lending -** Platforms that enable lending by retail investors to retail borrowers;
- **Crowd funding -** Platforms that enable fund raising through crowd sourcing;

[31] Australian Banking Association, based on calculations from annual reports of the 8 largest banks listed in the ASX200
[32] Fidoalliance.org

- **Payments -** New payment gateways or tools that facilitate payments;

There are domestic examples of some of the above offerings and some global players are also considering entry into the Australian market. We believe such innovations are reflective of customer needs and preferences, and therefore should not be impeded. By the same token, there may be increased risks to Australian consumers to the extent that activities fall outside the regulatory, licensing and consumer protection framework. Therefore, policy makers and regulators will need to facilitate progress while remaining vigilant with respect to emerging consumer issues or systemic risks.

5.5 Payments infrastructure

We reiterate our support for the findings and recommendations put forward in the RBA Payment Systems Board Strategic Review of Innovation in Payments Systems (2012). We recognise the value these changes will bring to the efficiency of the payments system, and acknowledge the impetus the review has given to advancing the payments system in Australia, with many of the aspirations expressed by the RBA now being carried through at an industry level in the build-out of the New Payments Platform (NPP) program.

As the industry implements the NPP, we reiterate the need for ensuring:

- that there are no overly onerous barriers posed in terms of technology or size for participation in the program; and
- there are relevant levels of representation and input from all stakeholders involved in payments - for example, consumers, banks (of all sizes), industry bodies, regulators, and technology providers.

The NPP is an important step forward in encouraging broader, cost-effective participation in the payments system, regardless of size or technological capability of the participants. We are confident at this stage that it will deliver against the RBA's and the industry's aspirations.