

## **Regulatory Insight: Missing the elephant in the room – the financial systems enquiry interim report**

*By Niall Coburn*

On 15 July, 2014 David Murray released his interim report about the Australian financial system. The report pointed out some key issues including flagging changes to the operation of the superannuation industry. On reviewing the report, it appears to me that it was a lost opportunity to look at some real issues for average Australians. The report ignored some of the big questions, such as why we pay twice the interest rates of our European and American counterparts and why the four big banks dominate our investment landscape with no sign of competition on the horizon. The report also did not discuss the rise in virtual banking internationally or the entrance of non banks, (such as supermarkets and airlines) into the financial services industry space and the implications for consumers. This article analyses the report and considers other important issues on the horizon.

### **The main issues arising from the report**

When I read the report, there is nothing in it that took me by surprise or was earth shattering in its recommendations. Most of the issues, if one reads main stream financial news each week, have all been canvassed maybe except for banning leverage in super and forcing people to buy annuities.

The major issues that David Murray raises are as follows:

- There is little evidence of fee based competition in the superannuation sector and that the fees and operating costs are higher than our international counterparts.
- People should not be allowed to accumulate debt in their super funds as this circumstance could ultimately jeopardise the country's financial system and steers towards a dangerous trend increasing risk.
- Consideration whether the banks should hold more capital and support for the approach of the Australian Prudential Regulation Authority (**APRA**) which told the banks to boost their capital levels by one percentage point from 2016.
- The report criticised the quality of financial advice standards and assessed whether education and competent standards in providing financial advice should be raised and a public register of financial advisers be established. It was also noted that there was confusion as to the boundary between general and personal advice. This issue was also raised in the recommendations by the Australian Senate in its report into the performance of ASIC in June 2014.

- Financial disclosure documents should be reconsidered by reducing the complexity and the lengths of documents to a shorter plain English version more readable for investors and by making financial disclosures more assessable through online tools.
- Financial products could also be improved to assist retirees and provide them with a wider choice of retirement income products. There should be incentives to encourage retirees to buy retirement income products or give them alternatives to convert all or part of their super benefit into an income stream that protects them against inflation and other risks.
- The report called on submissions whether there should be limitations on setting up small self-managed funds and the need for diversification of investments in this type of product.
- The report questioned the continuance of allowing negative gearing on investor housing as such an arrangement tended to encourage leveraged and speculative investment in housing and it was attractive to investors because they can deduct borrowing costs but any capital gains are taxed at half the modular rate. It was pointed out that this might be inconsistent with other investment savings where bank deposits are taxed at the individual's marginal tax rate as interest is earned on the deposits which make deposits less attractive.
- The report stated that because the Australian economy has become more open, the case for removing dividend imputation should be considered.
- Consideration was given to the need to change credit card fees and whether fees the banks impose for credit card transactions should be reduced or banned. It also pointed out that here was a case for allowing customers and retailers to have real time access to interchange fees and merchant service fees. It should be noted that the issue of credit card fees was the subject of a number of class actions before the Federal Court in Australia and in the UK, with courts coming down on the side of consumers.

## **Important issues left out**

### ***Reduction in interest rates***

One of the most interesting issues not raised in the report is the fact that Australians pay nearly twice the interest rates as their foreign counterparts in Europe and in America. This interest rate strain clearly effects the growth of the economy and its ability to be productive and meet the financial needs of Australians. If interest rates were much lower, it would mean that there would be a lot more freed-up capital to invest in different industrial sectors and loosen up funds for additional injection into superannuation schemes. The issue of interest rates raises the dominance of the big four banks in the Australian economy that effectively control interest rates and the way that capital is disbursed to the large and small business sectors. The interest rates

that Australians pay and the high bank fees across the board, have clearly added to the ever increasing large bank profits which have escalated in the past decade. It is suggested that David Murray and his team clearly need to look at this issue and what can be done to reduce bank interest rates.

### ***Competition landscape in Australia***

Under the Keating government, there was an attempt to de-regulate the banking sector and allow for more competition which in theory was supposed to drive down the cost of finance for the average Australian. The recessions in the 80's and the 90's clearly had an impact and bank consolidation accelerated where the smaller players such as RAMS, State Banks of South Australia and Victoria, Bank West and others have been subsumed at different times into the major four that dominate and control the market and have emerged as the winners undergoing unprecedented growth. Tweaking of regulation in the early 90's making prudential rules robust ensuring that the major banks were resilient and stood firm during the global financial crisis emerging more powerful and profitable.

However, now there is no competition and what has emerged is clearly a fixed finance market. Although the Murray report examines whether there is any systemic risks in the banking sector, it steers completely away for the need to inject more competition. That said, competition appears to be arising for the most unlikely sectors with main supermarkets now offering loans and insurance products. Additionally, airlines are offering credit type card arrangements under exemptions provided by ASIC. This is another area that needs to be looked at closely and could have been subject to more attention in the enquiry.

### **Rise of Virtual banks internationally**

The Murray report does not look in any depth at the growth of "Virtual banks" and the impact of these new digital banks will have on the Australian financial system in the next decade. Virtual banks appeal to the socially connected young consumers. More than ninety per cent of all transactions in the developed market are now done via non branch channels and this will only increase in the coming years, making virtual banks more relevant.

What has changed is that it is far cheaper to set up a new bank with up to date technology platforms than over haul an old one. In the UK for example, Metro and Aldermore, two new virtual banks were set up for fifteen million pounds. These innovative start up banks focus on consumer needs making the digital relationship easier for on line users and lend to small businesses and provide medium home loans. Recently, BBVA Chief Executive, Francisco Gonzalez stated that big banks are not prepared for this rise in new competition. BBVA, last year acquired a new Virtual bank "Simple" for US\$117 million and in doing so obtained 100,000 customers.

Australian Banks, the most profitable internationally, are priced as if their current high returns will be retained. However, we can learn from UK banks, and see that the financial market will be subject to intense innovation in the next decade bringing new and cheaper players and products into the market. It is only a matter of time when Australian households will have access to

cheaper loans internationally and this is something that the big four in Australia appear to be ill prepared for that challenge. The developments overseas appear to indicate that the big four may have had their time in the sun.

### ***Managed investment schemes***

The report also flags that more should be done to attract foreign investment into Australia's managed investment schemes. However, it fails to point out that our managed investment schemes laws are flawed and that average Australians have lost their retirement money in the last five years through ineffective and legally flawed managed investment schemes.

Since the 2008 GFC, approximately ten to fifteen billion Australian dollars has been lost to Australian and international investors in retail and wholesale Managed Investment Schemes that are registered and licensed by ASIC. These schemes replaced the old trustee fund arrangements, and were introduced under the Corporate Law Reform Act in 1992. The new responsible entity structure (which replaced trustees) allows for conflicts of interest and low-grade risk management programs.

The civil and criminal provisions under the *Corporations Act* (that were supposedly drafted to pursue criminal contraventions) are incapable of being used because of their cumbersome drafting and high onus of proof. To my knowledge, there have been no prosecutions under section 601ED of the *Corporations Act*, even though many elderly and foreign investors have lost funds in fraudulent circumstances under these schemes. The entire managed investment chapters and contraventions need reform. This continued recipe for disaster does not receive any attention in the Murray report.

### ***Investor losses***

In the call for increased financial advice standards and conflicted remuneration structures, in the financial advice industry, there is little in the report that assesses how Australians, especially retirees lost billions of dollars of their investment portfolios at the hands of investment advisers. This would have to be within one of the core objectives and principles of the financial enquiry which was supposed to focus on how the financial system could most effectively help the Australian economy and be productive, grow and meet the financial needs of Australians.

### **Going forward**

If the report in the future is to look up to its own objectives and principles, it has got to seriously look at why the average Australian pays more interest for their mortgages and more bank charges than anywhere else in the world. One of the main reasons is obviously the total lack of competition in the market. Although the financial system as David Murray states, "has performed reasonably well", few Australians would agree that their needs are being met by the big four in terms of the price they pay for capital and the difficulties that small business have in obtaining loans from the big four. Maybe these are issues may provide food for thought during the next six months having regard to the objectives and principles that underpin the Enquiry.