MACQUARIE

Financial System Inquiry

Submission by Macquarie Group in response to the Interim Report

August 2014

Contents

1. Introduction and Context

Macquarie Group appreciates the opportunity to respond to the Interim Report of Australia's Financial System Inquiry, following its first round submission in March 2014. The views reflected in that submission remain current.

We acknowledge the breadth and depth of the Interim Report, and concur with the Inquiry's initial assessment that the Australian financial system has performed reasonably well in meeting the financial needs of Australians and facilitating productivity and economic growth. We agree that many areas of the financial system are operating effectively and do not require substantial change.

As an Authorised Deposit-taking Institution ("ADI"), we share the Inquiry's assessment of the importance of stability in the financial system, specifically in the banking system. We contend that Australia's banking system is well-regulated by international standards, largely due to pro-active and rigorous supervision of Australian institutions that is focused on the prevention of systemic issues. Notwithstanding that Australia's banking system proved resilient during the global financial crisis, it is prudent to objectively assess policy alternatives under consideration in other jurisdictions around the world to promote systemic stability.

At the same time, it is important to recognise that Australia's banking ecosystem, and Australia's prudential and regulatory frameworks, have subtle but significant differences to those found in many of these jurisdictions. Policy alternatives deemed appropriate in these markets may be less relevant in Australia. Consideration of policy options from other jurisdictions is a healthy process, subject to an objective assessment of whether these options are appropriate and workable in an Australian context and how the application of these options will affect the efficiency (incremental costs and benefits compared with the present framework) and effectiveness of a financial system that has proven stable and resilient through the testing times of the global financial crisis. We are firmly of the view that the adoption of policy options in overseas jurisdictions is not, of itself, a compelling reason to introduce those policies in Australia.

In this context, we have provided some comments in Section 2 on specific stability policy options raised in the Interim Report, namely "ring fencing", "bail in", and the deposit guarantee threshold.

Well established corporate law principles regarding the roles of Boards and management have served Australia well. We support the observations made in the Interim Report on corporate governance. In Section 3, we provide further comment, along with possible solutions to address uncertainty introduced by some recent prudential standards and guides.

In establishing policy settings for Australia's future, ensuring Australia remains internationally competitive is essential. This includes setting domestic regulation that is appropriate for Australia while facilitating Australia's development as a financial centre, allowing local firms to export financial services and operate internationally, and facilitating access by Australian firms to offshore financial markets. Failure to maintain Australia's competitiveness or having uncompetitive regulatory settings risks financial services activity bypassing or relocating from Australia. We reiterate comments made in our first round submission on making Australia internationally competitive (Section 2) and the effects of regulation (Section 3).

Client monies is an area of regulation we need to get right and we discuss this in Section 4.

2. Stability: Additional Policy Options

2.1 The Australian context

Notwithstanding a number of financial crises, Australian depositors have not suffered a loss since 1890[1]. The performance of the Australian financial system through the global financial crisis has been markedly different to that of other developed countries affected by that crisis, where consideration of various stability-focused policy options have received most attention. While the Australian government provided some funding support (in the form of guarantees, for which the Australian Government has received significant payment from Australian banking institutions), no Australian bank failed or required recapitalisation from the government during the crisis. The support for funding provided was due in part to Australia's structural reliance on foreign funding (as highlighted by the Inquiry in the Interim Report), the availability of which was affected by the crisis, and in no part due to weakness in the asset or capital strength of the banks.

The resilience of the Australian financial system during the global financial crisis, in comparison to those of Europe and the US, can be attributed to a number of factors. These include the underlying resilience of the Australian economy, the strong fiscal position of the Australian government, the lower risk appetite of Australian banks and APRA, as well as some distinct characteristics of its banking sector:

- Australia's banking sector is generally smaller both in absolute and relative terms[2].
- Australia's banking sector is largely domestically-focussed. Although Australian banks consistently access international markets for funding, the extent of international banking activity is low in comparison to domestic activity for the Australian banking sector as a whole[3]. That is, the risk of 'imported contagion' is lower in Australia.
- Australia's banking industry is largely focused on retail and commercial banking, with low levels of investment banking and trading in comparison to many other countries.
- Australian banks have "less complex trading books, compared to North American or European institutions"[4].
- Australia is one of the few countries with a statutory depositor preference regime[5], under which depositors have preferred legal status over unsecured creditors of a failed ADI. That is, depositors need to be repaid before unsecured claims.
- The number of banks in Australia is small in comparison to Europe and the US, which both have thousands[6] of banks to regulate. The concentrated nature of our system and the small number of banks means that the Australian regulator has the capacity to focus on each bank, including all its non-retail activities.

Prior to the GFC, Australia's banking system did not copy approaches in other jurisdictions, but rather designed and implemented a stability framework and regulatory approach that reflected the distinctive characteristics of the Australian banking system. In this context, the Interim Report notes that whilst the GFC tested both the resilience of the financial system generally and the performance of its regulators, Australia's approach to financial stability proved resilient during the GFC [page xxv].

[1] Page 61 of the Reserve Bank of Australia's Submission to the Financial System Inquiry
[2] See for example, p37 of the ABA submission to the Inquiry
[3] International assets of the Australian banking sector are relatively small and lower than many other countries as a proportion of GDP. For example, at 29% of GDP, international assets of Australian banks is comparable to Canada and the US but well below the UK, France, Germany and Switzerland. Australia's net liability position (evidencing the reliance on offshore funding of domestic assets) is also notable. See for example "International Activities of Australian Banks", Bailey, van Uffelen and Wood, RBA Bulletin December Quarter 2012, page 2.
[4] Find ref, from P3-19 of the Interim Report
[5] Page 61 of the Reserve Bank of Australia's Submission to the Financial System Inquiry
[6] The US FDIC has noted there were 6,730 federally insured financial institutions in the US as at March 2014 (FDIC website). The ECB has noted that there were 8,746 "monetary financial institutions" in the European Union as at the end of 2013 (http://www.ecb.europa.eu/press/pr/date/2014/html/pr140121.en.html)

Post-GFC, Australia was quick to include additional measures such as Basel III (for example, increased capital requirements and more stringent liquidity requirements) and increased capital requirements on D-SIBs. These were often implemented in advance of international deadlines, further bolstering the relative position of Australian banks and the stability of the Australian banking system. We note that APRA has increased its regulatory resources over recent years, allowing it to "maintain a heightened intensity of supervision" (see page 48 of APRA's submission to the Inquiry).

In its submission to the Inquiry, the Reserve Bank of Australia observed

> *Although much attention internationally has been directed at changing policy frameworks to limit systemic risk and promote financial stability, the Bank considers that the current arrangements in Australia for financial stability policy and regulatory coordination are working well, and does not see a case for significant change. (pp43-44)*

This context is important. Ring-fencing and bail-in, posed for consideration in the Interim Report, would involve fundamental structural changes to Australia's banking and creditor framework. These policy options are part of a broader dialogue on recovery and resolution issues that are still subject to extensive discourse overseas that is yet to be finally or uniformly settled.

We would contend that, notwithstanding the proposed or potential adoption of new policy options in some overseas jurisdictions, any contemplation of substantial change to Australia's regulatory framework needs to be appropriate to and workable in an Australian context, and not compromise the efficiency and effectiveness of a system that has served its stakeholders well through stern tests.

2.2 Ring fencing

The concept

As noted in the Interim Report [3-18]:

> *The goal of ring-fencing is to 'carve out' specific financial activities to protect them from other activities that are less critical to economic activity — and are likely to be riskier. This might involve separating commercial banking from investment banking, or insulating domestic operations from risks in offshore activity*.

Implementation

The concept of ring fencing has a number of interpretations and there is not international consensus on how it is defined or will be implemented. For example, the UK approach (based on the Independent Commission into Banking) is for domestic retail operations of domestic banks to be "fenced-off" from their trading activities by 2019. The European Commission published the Liikanen report which recommended ring fencing of the trading arms of certain (but not all) European banks from retail and commercial banking operations. It is not clear when or if the Liikanen report will be adopted, and it appears that France and Germany may be moving ahead with plans of their own[7]. In an alternative approach, the US is looking to a ban on proprietary trading and investment in hedge funds under the Volcker rule.

Benefits

The potential benefits from ring-fencing could include a reduction in the complexity and interconnectedness of institutions within the ring-fence, which arguably reduces the likelihood and cost of any bank failures, and improving the resolvability of ring-fenced businesses (but not other members of that group) in the event of a failure. In considering the proposed UK ring-fence contained in the ICB Report, HM Treasury suggested there is a net present value benefit of the UK ring-fence; however, these benefits are largely contingent, and difficult to objectively quantify[8]. Noting that Australia did not have a similar banking crisis and the nature of the Australian banking system, it is questionable if a similar analysis would be valid for Australia.

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[7] based on ring fencing proprietary trading activity, although the French proposal includes investment in and unsecured trading with hedge funds, certain high frequency trading activity and some soft commodities trading.

[8] the quantification of the benefit was based on modelling a lower probability of default and loss severity for future banking crisis, so largely assumption driven

Costs

Implementation of ring fencing will come at a material cost for the structural separation, including establishing new operating entities, separating IT and administrative platforms and duplication of certain central functions. It will reduce diversification benefits and operating efficiencies. To meet separate capital requirements for the ring fenced and non ring fenced banks, the banking group may need more capital and overall funding costs may increase[9], particularly if loss of diversification and/or scale lead to adverse ratings outcomes. Any fragmentation of essential risk management or treasury and liquidity management functions will be a net negative for the financial system. We note there will be substantial and real (cash) costs to the financial system[10]:

There is also the potential cost and impact to consumers of financial services, particularly where clients need services "across the divide". These may include impacts on SME's where foreign exchange or hedging services could not be provided on a basis that takes account of cash deposits and other security and collateral; on individuals with restrictions on structured deposit or other investment products; or on corporate clients if the ring fence included commercial banking and certain essential functions could only be provided outside the ring fence[11]. In Australia, the position and needs of superannuation funds (including self managed funds) needs to be considered.

The ability of Australian banks to support the resources sector is essential for our economy. This includes corporate financing (including senior secured and unsecured lending, capital markets financing, mezzanine debt and equity), collateral financing (including repos and a range of structured commodity financing products), and provision of hedging (through various commodity and FX derivatives). It is critical that Australian banks remain able to provide the full range of products that support our resource sector.

Australian context

Contrasting with the Australian experience, a number of major North Atlantic countries experienced the failure of, and/or required material financial support from governments for, one or more major banks during the global financial crisis. Large banks in many of these countries operate extensive international businesses (in many cases including large international trading activities), exposing banking operations in their home markets to the risks of these international operations.

With the predominantly domestic and retail/commercial banking focus of the Australian industry and the nature and relatively small scale of international activities (outlined in Section 2.1 above), the need to carve out specific activities, such as investment banking, trading or international activity, are not obvious. For most Australian banks, the ring fenced entity would comprise the vast majority of existing activity, in which case we query its efficiency and effectiveness.

None of the proposed ring-fencing regimes overseas have yet been implemented. The practicalities and effectiveness of ring-fencing therefore remain largely untested. With relatively low level of investment banking in most Australian financial institutions, any carve out of investment banking activity will be difficult (especially where related to and tied in with commercial banking activity, for example) and may result in carved out entities that lack diversification and scale, leading to the question of whether they are viable on their own. To the extent they are not (and possibly even otherwise), a number of these activities may increasingly be conducted in unregulated entities, or in non-retail-bank entities that require regulation, hence fragmenting the regulatory approach. The costs of fragmenting the regulatory approach and of promoting growth in the unregulated space may be considerable.

The potential benefits of ring-fencing are obtainable (and arguably are being obtained) by continued pro-active and prudent supervision of Australian banks by APRA, and that it is within APRA's remit to take action as regards businesses or activities undertaken by an ADI that would place the system at risk. In this context, the Interim Report notes [1-18]:

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9 See for example, the UK Treasury's impact assessment for implementation of ring fencing in the UK
10 See for example "Ringfencing UK Banks – More of a problem than a solution", Policy Exchange2013 pp61-62
11 See British Bankers Association's response to the Independent Commission on Banking, 12 March 2012, page 2

> *A factor contributing to Australia's resilience during the GFC was its strong prudential framework. Australia's prudential rules, often tighter than minimum international standards before the GFC, together with a proactive approach to supervision, helped maintain a healthy and stable financial sector domestically*

The incremental benefits of ring-fencing, over and above Australia's existing supervisory regime, are likely to be marginal and highly uncertain. By contrast, the costs of introducing ring-fencing will be material and real (i.e., cash costs).

As noted in the Interim Report (page3-19):

> *Ring-fencing would come at a cost. Of the measures discussed in this section, it is likely to be the most burdensome. It involves costs to institutions of restructuring, ongoing efficiency costs through reduced diversification benefits, and may introduce barriers to foreign entrants and limit Australian banks' ability to expand internationally.*

Therefore, we submit that ring-fencing is not appropriate or workable in the Australian context, nor does ring-fencing make the Australian financial system more efficient or effective for its stakeholders. We believe ring-fencing would make banking in Australia more expensive but not necessarily safer.

2.3 "Bail in"

The concept

Bail-in resolution strategies generally result in certain unsecured liabilities of a distressed financial institution being written down or converted to equity to recapitalise the institution, without a requirement for the institution to pass through a period of insolvency. A bail-in regime is not designed to reduce the likelihood of financial distress of a banking institution, but transfer the risk of loss from taxpayers to unsecured creditors, reducing the need for government funds to be used to support failing financial institutions. It is important to note that a bail-in regime is one of a number of possible resolution powers that may be implemented and utilised by a regulator, alongside other such powers as resolution plans and simulations.

Implementation

Bail-in can cover capital instruments (like Tier 2 instruments), debt instruments, or business transfers where viable parts of a business are transferred out leaving lower ranked debt in failed institutions to be wound up[12]. The Vickers Report noted[13]:

> *Bail-inable debt acts in a similar way to contingent capital, by recapitalising a bank through the conversion of debt into equity or through debt write-down. However, unlike with contingent capital, this occurs when a bank is put into resolution, and so would require intervention by the regulator. While its effect may be to allow some of a bank's operations to continue as a going concern, it may simply facilitate a solvent wind-down in resolution*

The types of liabilities covered by bail-in arrangements are subject to debate. As noted by the Independent Commission on Banking in the UK, the focus of bail-in is on long term unsecured debt as other liabilities are either 'protected' or subject to systemic risks: Ordinary deposits are excluded, imposing losses on derivative counterparties would prompt close out of contracts causing disruption to financial markets and raising the risks of indirect losses, likewise imposing losses on short term unsecured debt and uninsured deposits would cause disruption to funding markets and act as a channel for contagion to other financial institutions, and there would be systemic risks involved by including central counterparties[14]. It is necessary to consider whether the disruption and contagion issues noted by the ICB above for other types of liabilities will arise for long term senior unsecured debt in the Australian context.

As noted in the Interim Report (page 3-11), there remain a number of fundamental questions on how implementation of a bail in regime would work including:

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[12] See RBA submission to the Inquiry, page 48
[13] See Independent Commission on Banking (ICB) Final Report recommendations – September 2011 pp 100-101
[14] See Independent Commission on Banking (ICB) Final Report recommendations – September 2011 pp 100-101

questions around the nature of the liabilities that may best be able to absorb losses in resolution; ensuring that relevant creditors are capable of bearing loss without systemic contagion; appropriate mechanisms and triggers for imposing losses on creditors; interaction with the existing regulatory capital framework; and the effect on funding costs in normal times.

Despite considerable discussion and debate, how "bail-ins" will work and be priced by the market remain conceptual.

Benefits / costs

The arguments for and against bail-in are well set out the RBA's submission to the Inquiry (p48), reproduced below (emphasis is ours).

> *The main argument for bail-in is that it transfers the risk of loss from taxpayers to unsecured creditors. Some argue that increasing the responsibility of unsecured creditors - which should encourage more appropriate pricing of default risk - may also strengthen the market discipline of financial institutions that might not otherwise fully internalise the social costs associated with their operations (Mishkin 2006; Tarullo 2009). <u>It is not clear, however, that this is necessarily a stronger mechanism than shareholder discipline</u>.*
>
> *<u>The arguments against bail-in include the risk of exacerbating a financial distress situation by causing uninsured and unsecured short-term creditors to withdraw funds to avoid being bailed-in, or by making it less likely that financial institutions will be able to roll over long-term debt. Bail-in may also cause contagion if debt held by other financial institutions is bailed-in, or if it raises concerns that creditors to other banks in the same jurisdiction will also be bailed-in in the near future.</u> Furthermore, to the extent that the existence of statutory bail-in powers encourages particular types of investors to demand more secured debt relative to unsecured debt, some types of unsecured creditors – such as suppliers – may become more exposed to losses.*
>
> *The arguments against bail-in do not preclude its inclusion in the suite of available resolution tools. However, they do suggest that implementation needs to be carefully considered and should proceed cautiously in order to avoid unintended adverse consequences. The arguments for conservatism in the implementation of bail-in are further supported by the observation that there are few, if any, examples of banks which have successfully been resolved as going concerns through the use of bail-in powers alone.*

In summary, bail-in aims to reduce the size of loss to tax payers in the event of the failure of a banking institution, but may do so at the cost of exacerbating the likelihood of financial distress, by bringing forward the time at which unsecured / uninsured creditors will seek to withdraw funds from a distressed institution.

Australian context

Bail-in represents a significant change to Australia's regulatory framework. Contemplation of bail-in, like ring-fencing, should only occur where an objective assessment determines that it is appropriate to and workable in an Australian context, and not compromise the efficiency and effectiveness of a system that has served its stakeholders well through stern tests.

It is important to emphasise that, despite considerable discussion and debate, bail-in regimes as contemplated remain untested, and so the effectiveness or workability of bail-in instruments as a resolution mechanism cannot be measured. As noted by the Federal Reserve Bank of St Louis:

> *...the credibility of the (bail-in) approach won't be known until it is actually tested[15].*

We also note that, unlike many other jurisdictions, no Australian bank failed or required recapitalisation from the government during the crisis. Australian taxpayers did not suffer a loss in the recent financial crisis; in fact, payments from the Australian banking system to the government run to billions of dollars for providing guarantees to the Australian banking system during the GFC[16]. As a result of all these factors, we remain

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[15] "From Bailouts to Bail-ins: Will the Single-Point-of-Entry Concept End "Too Big To Fail"?, Jim Fuchs, Assistant Vice President, Federal Reserve Bank of St. Louis, Summer 2013

[16] At January 2010, fees totalled A$1.2 billion and were estimated to be running at A$0.1 billion per months: "The Australian Government Guarantee Scheme" by Carl Schwartz published in the RBA's Bulletin March 2010.

unconvinced that a tangible benefit would accrue to Australian taxpayers, or stakeholders in the Australian banking system, as a result of the implementation of a bail-in regime. At the same time, there are immediate tangible costs incurred by stakeholders in the Australian banking system, largely in the form of higher funding costs. We would expect that bail-in would result in a net cost to the Australian banking system, and therefore the Australian taxpayer.

As noted in Section 2.1, a distinctive feature of the Australian banking system is the reliance on offshore wholesale funding. The Interim Report notes:

> *Australia typically has had more abundant domestic investment opportunities than could possibly be funded from historic levels of national saving, and has therefore recorded persistent current account deficits [2-45];*
>
> *Australia is therefore exposed to the risk that foreign debtors may choose to withdraw funding when the debt matures, particularly in times of stress [p2-47]; and*
>
> *When funding markets were dislocated during the GFC, Australian ADIs found it difficult to roll over short term debt and to obtain wholesale funding...These events made it more difficult for ADIs to meet the demand for credit and led ADIs to their funding risks [2-79 to 2-80]*

This reliance on offshore funding poses a number of issues for bail-in. Recapitalisation through bail-in is only successful if the confidence of creditors is restored, either in the bailed in institution if it is to continue as a going concern or in the overall financial system if contagion effects are to be avoided.

For a bailed-in institution to remain a going concern, creditors need to remain willing to lend to it. This is questionable for offshore creditors who have suffered a loss and/or been converted to equity, or for offshore creditors who have alternative investment opportunities. Further, the existence of bail-in triggers (whether explicit or contingent on regulatory action) can bring forward the point of market uncertainty. That is, should there be a fear of possible bail-in, debt holders will (quite rationally) seek to exit their investment. This will be so whether or not the financial institution may in fact be viable.

Importantly, because of the reliance on offshore funding on a system wide basis, the risks of exacerbating the crisis and causing contagion outlined in the RBA submission are distinctly more pronounced. That is, investors fearing bail-in of one Australian bank may invoke a run on another bank (again, quite rationally) to avoid any flow on contagion. As a result, the overall stability of the system is likely to be weakened rather than strengthened, by bail-in. Recently, Moodys, the ratings agency, has noted[17]:

> *Given Australian banks' reliance on wholesale funding, and the role of external inflows to finance Australia's structural current account deficit, risks of contagion from implementation of bail-in provisions may be especially high.*

We also note that domestic investors provide funding to Australian banks. In this case, the use of bail-in merely shifts the costs of the bank distress to those investors.

As noted above, the uncertainty and costs associated with bail-in regimes are substantial for stakeholders in the Australian financial system, and the tangible benefits to both Australian taxpayers and these stakeholders are difficult to quantify, if any exist. In this context, and given the reliance upon foreign funding of the Australian banking system, there appears little benefit in accelerating any discussion relating to the introduction of specific bail-in resolution regimes ahead of other jurisdictions.

2.4 International developments

Work continues to be done at the international level on recovery and resolution issues more broadly and there is no internationally consistent approach at this point[18]. The G20 continues to consider these issues and it is expected they will be debated when it meets in November this year, followed by a period of public consultation and a Quantitative Impact Study. At the very least, we would suggest that international developments be allowed to play out in full (with input from Australia) and further evidence gathered and

[17] Special Comment: Asia Pacific Banking Systems: A Compendium of Bank Resolution and Bail-In Regimes in the Asia Pacific, 24 July 2014, page 3

[18] For example, proposed implementation of ring fencing in the UK as a result of the Vickers report is not expected until 2019, while it is not clear that ring fencing proposal from the Liikanen report (which differ from those in the Vickers report) will in fact be implemented in Europe

examined (including on the potential impacts to the financial system more broadly). Then, any final policy determinations need to be made ensuring they are appropriate for Australia.

We echo comments made by the Reserve Bank of Australia (in respect of bail in bonds, but in our opinion, equally applicable to ring fencing) that any proposed implementation needs to be "carefully considered and should proceed cautiously in order to avoid unintended consequences"[19]. As a point for consideration, we note the downgrade of the outlook for Canadian banks by both Moodys and Standard & Poors following the release of a bail in consultation paper by the Canadian government.

2.5 Financial Claims Scheme

The Inquiry has sought comment on modifying the Financial Claims Scheme, including the appropriate threshold for the FCS guarantee of deposits (Interim Report 3-18). In 2011, Treasury sought comment on, inter alia, the appropriate threshold for the guarantee of deposits. Following a period of consultation, the level was reduced from A$1 million to A$250,000. Given the relatively recent change, and the importance of deposit guarantees for stability in the financial system, we do not believe any change in the threshold is warranted at this point.

We note that the existing threshold has maintained:

- stability of the system (or as the Interim Reports notes "the deposit guarantee aims to give depositors confidence in the safety of their money during a crisis, preventing panic and bank runs that may exacerbate the crisis" [3-16])

- competition in the market for deposits (or as the Interim Report notes "in the context of reducing the effects of too big to fail, the FCS assists smaller institutions" [3-16])

- deposit coverage (the Interim Report notes that "the scheme fully covers 99% of eligible depositors and over half of deposits by value" [3-16])

There are aspects of the FCS that should be examined. It remains complex, and ways to reduce this should be examined. In this regard we refer to submissions from the Australian Bankers Association.

The Inquiry has sought comment on the introduction of an ex ante fee. We do not believe this is appropriate and again refer to submissions from the Australian Bankers Association. As noted in the Interim Report, any such fee is likely to be passed on to depositors (page 3-17).

[19] Page 49 of the Reserve Bank of Australia's Submission to the Financial System Inquiry

3. Stability: Corporate Governance

Macquarie is supportive of further examination of two issues raised by the Interim Report [3-48]:

- Review prudential requirements on boards to ensure they do not draw boards into operational matters; and
- Regulators continue to clarify their expectations on the role of boards.

As identified in the Interim Report, the traditional delineation of responsibilities between the board and those of management should not be altered by regulation [3-45].

In our view, various APRA Prudential Standards impose obligations and responsibilities on Boards which go beyond the ‘independent and objective oversight’ role normally attributed to Boards. In this regard, we do note the positive steps taken recently by APRA to address this issue in relation to a recently published standard and draft guide, CPS 220 and CPG 220, the outcomes of which are yet to be published. However, the same issues have not been addressed in many other APRA Prudential Standards and Practice Guides.

While it is essential that APRA considers whether Boards and management of regulated institutions are taking a prudent approach to risk management matters, Boards themselves need to have the freedom to decide which roles and responsibilities are best discharged by the Board and which roles and responsibilities sit more appropriately in the remit of management.

Macquarie has identified 116 separate obligations in APRA’s Prudential requirements which are placed on the Board, some more onerous than others, some expressed with confusingly different terminology, and very often with little specific guidance as to how to fulfil these obligations. It requires further consideration by APRA as to which obligations actually require the specific attention of the Board. Those obligations should be clearly enunciated so as not to place unfair burdens on Boards, either as to expertise, imposition of time or interpretation.

There are also many examples where the Prudential Standards make collective references to the dual roles of ‘the Board and senior management’ which also causes interpretative difficulties and further blurs the functional separation in roles and responsibilities between the Board and those of management. In our view, this issue could be quite easily addressed if the references to ‘Board and senior management’ in all standards and guides were replaced with a reference to ‘APRA-regulated institution’.

As stated above, of fundamental importance to good corporate governance for any organisation is that Boards are free to decide the allocation of responsibilities between the Board and management. To this end, and in accordance with well accepted corporate law principles, Boards of major enterprises frequently make and should not be restricted in their use of extensive and appropriate delegations to management while reserving important decision-making responsibilities for the Board itself.

If APRA needs to be prescriptive in its Prudential Standards by imposing specific obligations and responsibilities on Boards, then it is critical that APRA does not limit or restrict the ordinary principles of good corporate governance that allow Boards to delegate and rely on management where appropriate in order to carry out that responsibility (noting that a director must still adopt an enquiring approach and exercise their own independent judgment on the quality and adequacy of the inputs when so relying).

We would recommend that a full review be undertaken of APRA’s Prudential Standards and Practice Guides in accordance with the above.

4. Australia’s competitiveness and financial integration

In establishing policy settings for Australia’s future, ensuring Australia remains internationally competitive is essential. This includes setting domestic regulation that is appropriate for Australia while facilitating Australia’s development as a financial centre. This would better allow local firms to export financial services and operate internationally, and better facilitate access by Australian firms to offshore financial markets.

Failure to maintain Australia’s competitiveness or having uncompetitive regulatory settings risks financial services activity bypassing or relocating from Australia. We reiterate comments made in our first round submission on making Australia internationally competitive (Section 2) and the effects of regulation (Chapter 3). Our comments in that submission on the client monies regime in Australia provide an example of the need to get domestic regulation right.

The rules in this important area lack transparency (for example, regulation and / or regulator expectations are contained in regulatory guides, class orders, class waivers, individual orders and individual waivers granted by ASIC, Market Supervision Updates issued by ASIC and other information sheets, reports, gazettes and regulator publications) and are often difficult to interpret. They are at times duplicative, in that there is more than a single client money regime in Australia. For example, ASX, ASX24, FEX and Chi-X each have their own client money provisions contained within corresponding market integrity rules, which are each also impacted by the Corporations Act regime. For participants who service clients across multiple Australian (let alone international) markets, the procedures required to simultaneously comply with divergent requirements add needless operational complexity. This increases general risk in the market. It also may make the regime difficult for clients to understand, and may give rise to differences of interpretation of the law between licensees and regulators. We believe the client monies rules in Australia need to be simplified for all participants.

Additionally Australian client money requirements interact very poorly with foreign regimes in a number of areas, and this represents a barrier to Australia’s financial integration with the rest of the world. An example is where an Australian client wants to trade on both a UK and an Australian exchange-traded market through an Australian broker. The Australian client money rules will only apply to trading on the Australian exchange, as moneys received from the client in connection with the UK exchange trading does not necessarily fall within the definition of “client money” for the purposes of Australian law. Such moneys are left to be governed solely by the UK regime. This bifurcation makes margining for derivatives products extremely difficult for brokers, and represents loss of efficiencies and offsets for clients. There is insufficient flexibility in the Australian regime to address issues such as this one. These difficulties could quite easily be resolved with substituted compliance or mutual recognition processes.

The Inquiry has observed in Chapter 10 of the Interim Report that “domestic regulatory processes could be improved to better consider international standards and foreign regulation, including processes for collaboration and consultation for international standard implementation, and mutual recognition and equivalence assessment processes”. We concur with this. With Australian client money regulation, there is an opportunity to implement these objectives.

Specific and considerable benefits to Australian financial markets could result from amendments being made to Australia’s client money regime. This would achieve a number of objectives, chief among which would be to ensure that client money remains as well protected by the regulatory regime as is possible, and that such regime is optimally suited to the significant reforms taking place in financial markets globally.