Business Council of Australia

Submission to the Interim Report of the Financial System Inquiry

SEPTEMBER 2014

The Business Council of Australia is a forum for the chief executives of Australia's largest companies to promote economic and social progress in the national interest.

About this submission

This is the Business Council of Australia submission in response to the Interim Report of the Financial System Inquiry (FSI). The Business Council looks forward to further opportunities to discuss the issues raised in the report with the inquiry team and to comment on any future draft or final recommendations.

Key recommendations

Recommendation 1: The final report should make a clear assessment of the ability of the financial system to become more globally competitive and to efficiently fund future growth in the Australian economy, and use this assessment to first identify and then test its policy recommendations.

Recommendation 2: Given the interim report's generally positive findings about the competitiveness and stability of Australia's financial system, and its integration with global regulatory frameworks, the FSI should not recommend further regulation of the banking system that could harm prospects for funding Australia's future economic growth.

Recommendation 3: Some key areas to focus on in the final report are:

- regulatory settings that can accommodate the rapid pace of technological change
- the need to diversify funding sources to reflect changed approaches to savings and to avoid problems experienced in the global financial crisis
- funding innovation and risk taking by Australian businesses, which is critical for productivity growth and higher living standards
- regulator performance.

Overview of the FSI Interim Report

The FSI Interim Report provides a balanced assessment of the financial system and identifies many of the right opportunities, challenges and priorities for improving the system into the future. However, the Business Council is of the view that the final report should assess the financial system's ability to efficiently fund Australia's future economic growth. This assessment will be important for framing and testing the final set of policy recommendations.

The inquiry considers that the financial system 'must satisfy three principles: efficiently allocate resources and risks, be stable and reliable, and be fair and accessible.'

The key findings of the review against these principles, as the Business Council understands them, are:

- The banking sector is competitive, albeit concentrated. Some areas of regulation, however, may be holding back innovation and the adoption of new technology to improve service delivery.
- Australia's approach to financial stability proved resilient during the global financial crisis, and the system remains broadly well regulated. There is a need to align Australia's regulatory system with global practice but in a way that recognises the competitive strengths of our approach.
- While the draft report makes no direct finding, it infers that the financial system is fair and accessible, but that there are areas in need of change such as the effect of regulation and taxation on small to medium sized business lending and the complexity of financial advice for consumers.

The report also says that we will need to renew policy settings to prepare for future financial crises, further international integration, population ageing and technology change.

In response to the interim report, the Business Council makes three key observations:

- The final report needs a more detailed assessment of the challenges in the future for funding Australia's growth than was provided in the interim report.
- Major changes to banking regulation are not warranted.
- The review should prioritise removing constraints on the global competitiveness of Australia's financial system and its ability to fund future growth.

We strongly support the FSI's observation on fiscal policy. The report has an important message to the parliament that it is imperative that the government improves the budget position, recognising its importance for financial stability in Australia and given our reliance on foreign capital. The final report should place a high priority on maintaining Australia's AAA sovereign credit rating – recognising the broader benefits of this to Australia, including through flow-on effects to the credit rating of Australian banks.

Comments on the interim report

Assess the financial system's ability to fund Australia's economic growth

The final report needs to give greater consideration to the future challenges of funding growth in the Australian economy. This will provide a better context for the FSI's final findings and recommendations.

The discussion in the report about future economic challenges presents a useful discussion on both the need for productivity to lift growth in GDP per capita and also the fiscal costs of the ageing population (pp. 1–23 and 1–24). However, the report also requires a detailed assessment of the expansion in funding that will be needed to support growth in the population and the economy overall, and the sources of funding. On current projections Australia's population could be around 40 million by mid-century. This will lead to a significantly larger economy, with the financial system playing a critical role in funding that expansion.

Securing higher living standards for a larger population will require the financial system to fund substantial amounts of new capital investment. The financial system will need to finance expansion in the nation's industrial capacity, housing and infrastructure. It will need to effectively allocate capital towards innovative and productive investments and business activities, and thereby support a more productive and larger Australian population.

An effective financial system can help lift our economic growth rate above the average annual rate of 2.7 per cent a year projected in the 2010 Intergenerational Report and closer to the 3.5 per cent annual average achieved over the past 50 years.

This review is happening at a time when Australia's future growth rates are at risk of decline due to an ageing population constraining the relative size of the workforce. Globalisation and technological change are also intensifying, requiring Australian businesses to continually innovate to keep pace with international competition.

Australia's more immediate prospects for economic growth also illustrate the need for an effective financial services system. Growth over the next few years will be subdued by the difficult transition from the resources boom and the lack of a pick-up in business investment outside the resource sector. According to Treasury forecasts, total business investment is projected to decline by 5.5 per cent in 2014–15 and then decline a further 3.5 per cent in 2015–16. GDP growth is projected to remain below trend for the next two years.

Table 1: Business investment projections

	2014–15	2015–16
Total business investment	–5.5 per cent	–3.5 per cent
Real GDP growth	2.5 per cent	3 per cent

Source: Commonwealth Budget 2014–15

Volatility in economic activity of a similar nature can be expected in the decades ahead. Policy changes that lessen the system's ability to fund growth would worsen our economic growth prospects by limiting access to funds or raising the cost of borrowing.

The final report should include an analysis of the expansion in Australia's population and economy and use it to identify funding challenges and policy recommendations that will enable new business investment to drive Australia's future economic growth.

Do not fundamentally change banking regulation

The interim report generally finds the financial system to be competitive and well regulated and that integration with global regulatory frameworks has proceeded well. It then invites comment on a number of potentially significant reforms of banking regulation. In considering these options, in our view the report does not identify an obvious need for wholesale reform of the financial system nor for major additional regulation of the banking system.

The Business Council recognises that the FSI review panel is grappling with complex economic and policy matters and the particularly challenging issues involved with aligning Australia's regulatory frameworks with the emerging frameworks in other countries, many of which experienced severe system failure during the global financial crisis.

Unless a clear problem in Australia is identified, however, the panel should refrain from recommending major changes to current policy frameworks governing the financial system, as this can add to the cost, complexity and uncertainty in the sector and throughout the economy. They risk detracting attention from the important need for policy changes that will lift global competitiveness and the ability of the system to efficiently fund future growth. Any changes that are recommended in the final report should be clearly explained and be carefully designed not to add to regulatory risk or reduce incentives to finance opportunities to grow the economy.

There are three key areas discussed in the interim report where regulatory reform is being considered but, if not done well, could impose costs on the system and make it harder for the financial system to efficiently fund Australia's future growth.

Risk-weighting systems

First, the interim report identifies issues for competition arising from the different risk-weighting systems that apply to banks. While there may be pro-competitive benefits from addressing this issue, the report does not set out a compelling case for doing so by altering internal risk-based (IRB) weighting systems. Rather, a positive approach to reduce the gap should be preferred by tasking the Australian Prudential Regulation Authority (APRA) to find opportunities to improve standard risk-weighting systems or faster IRB accreditation for non-IRB banks. The system as whole can benefit from improved risk systems. By contrast, increasing internal ratings-based risk weights of those that use them, without a strong justification for doing so, would be expected to lead to higher lending costs for businesses and consumers with flow-on effects on the wider economy.

'Too big to fail'

Second, the interim report observes that a legacy of the global financial crisis is the perception of some banks being 'too big to fail' and also asserts, appropriately, that 'the Government should minimise the expectation of taxpayer funds being used to support the financial system.' However, we do not see that the interim report identifies a need to increase capital ratios for large banks 'perceived' to be too big to fail in order to reduce these potential costs to taxpayers. The lifting of capital ratios would not be without cost as it would flow through to higher costs of funds for business and consumers. This would be undesirable for funding future growth, especially in times of low investment activity such as the phase of contracting private business investment we are currently expecting, according to federal budget projections.

Additionally, it is not clear that under-capitalisation is a problem in Australia where recent experience has differed to other countries. Should there be another systemic global banking crisis then liquidity would arguably be a higher risk than under-capitalisation as it is more likely Australian banks would encounter difficulties borrowing offshore (as we saw during the global financial crisis). Having recourse to emergency liquidity arrangements is likely to be preferred. To the extent Australian banks need more capital it should be aligned with international regulation and the timing should reflect the current economic needs, recognising that lifting capital will result in additional economic cost.

Ring-fencing

Third, the interim report does not present a compelling need to ring-fence activities within banks. The business models of Australian banks do not tend to support substantial trading functions, and it would be costly to introduce in Australia and harmful to business innovation. It is not necessarily the case that Australia should follow the lead of other countries in this area of financial system regulation given differences in our financial system.

The stability of the financial system is critical, as is effective integration with global regulation, but getting policy settings wrong on these three issues could have significantly harmful effects on the wider economy. Excessively restrictive or risk-averse policy settings will curb the ability of banks to lend, raising borrowing costs and making it more difficult for business and individuals to access the credit they need to invest and create jobs.

Areas to strengthen in the final report

The Business Council urges the FSI to use this opportunity to prioritise policy recommendations that can make the system more globally competitive and able to efficiently fund the future growth in the Australian economy, and help to grow future living standards.

The inquiry identifies a number of areas where there are opportunities to make the system work better and these should be further explored. As the review rightly points out, globalisation, population ageing and technology change are key factors impacting on the financial system.

The Business Council urges the inquiry to make the following areas a key focus of the final report.

Regulatory settings that can accommodate the rapid pace of technological change

The inquiry can pave the way for the better use of technology in the delivery of financial services. The interim report observes that ‘technological innovation is a major driver of efficiency in the financial system and can benefit consumers’. In the final report we would like to see a list of regulations that are impeding the use of technology (compiled from submissions to the review) along with a recommended timetable for regulatory reform.

We agree with the policy options to adopt a policy principle of technology neutrality and to enable electronic service delivery to become the default. Further, Business Council members have nominated some areas to target such as modernisation of disclosure requirements to reflect emerging technologies, opportunities for oral consent or digital signatures to replace written consent, and enabling more opportunities for electronic identification and verification.

The inquiry should also identify opportunities to consolidate multiple government initiatives on digital security into a single coherent strategy. It should identify and facilitate where government and industry can work together to enhance security for businesses at risk of cyber attack.

Diversify sources of funding

The final report should make clear recommendations on the need to both diversify and secure high-quality funding sources in order fund future growth, particularly as Australia's superannuation system continues to grow and mature.

It should address disincentives that arise from the tax treatment of deposits relative to other investments due to the need to grow high-quality sources of funding. For instance, the Henry tax review identified very high real effective marginal tax rates for returns on bank accounts and recommended providing a 40 per cent savings income discount to individuals for non-business related net interest income. If taxation is not to be fully tackled in the FSI then the final report should provide the upcoming tax white paper process with arguments for reform that will address these distortions in the tax system and strengthen the financial system.

The final report should provide a realistic assessment of the opportunity to grow the corporate debt market. The report observes that 'a range of regulatory and tax factors have limited its development' and suggests two explicit policy suggestions around the issuance of vanilla bonds. We would like to see the wider set of factors also addressed.

The report should back measures that enable superannuation funds to invest in productive infrastructure, including by supporting direct investment through public asset sales (which can also assist governments to recycle capital into new infrastructure projects), or by growing opportunities for self-managed super funds to indirectly invest in infrastructure through debt instruments.

Funding innovation and risk taking by Australian businesses

The system must be better able to appropriately fund risk taking by businesses that is at the core of an innovative and productive society. In particular small to medium business growth is particularly important for innovation and employment growth, yet many find access to funds can be a barrier to innovation and growth.

Opportunities to grow lending to small and medium enterprises should be identified, especially where impediments to lending can be removed that add to costs.

The final report should investigate blockages and barriers to small and medium business lending and examine practices in other jurisdictions. Barriers can be financial, transactional, commercial or prudential in nature. The interim report does refer to ‘regulatory and taxation’ impediments, but does not go on to provide an extensive set of specific problems or policy solutions. We would like to see this discussion of regulatory and taxation impediments expanded in the final report. Areas for detailed policy solutions could include addressing information asymmetries, transactions costs and risk models associated with business loans.

Regulator performance

The positive performance of Australia’s financial system in recent years reflects well on our regulatory settings and the performance of Australia’s financial system regulators. However the review is an opportunity to ensure that oversight and accountability arrangements for regulators are proportionate to their powers and that regulator performance is subject to continual improvement.

We welcome the government’s recent initiative to issue Statement of Expectations and Statements of Intent. A rigorous measurement and reporting framework should be established to ensure these commitments translate into a real reduction in unnecessary red tape and compliance costs. The Business Council believes more generally that all non-economic regulators should promote economic progress in the discharge of their various functions.

We agree with the interim report’s observation that ‘substantial regulator focus on boards has confused the delineation between the role of the board and that of management’ and that this needs to be addressed.

As argued in the Business Council’s submission to the Competition Policy Review, the current price signalling provisions under the Competition and Consumer Act (which largely affect the banking sector) are poorly conceived and greatly disproportionate to any problem and should be repealed.

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