FSI Submission

26 August 2014

Building a better
working world

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Introduction

EY welcomes the Financial System Inquiry's Interim Report and applauds its collaborative approach to resolving a number of challenging issues. As a leading global professional services organisation, we have drawn on our international experience to respond to the questions raised.

This submission aims to assist the Financial System Inquiry (the Inquiry) in addressing a number of issues raised in the Interim Report released on July 15, 2014. It outlines our thinking on some of the policy options under consideration and answers a number of specific questions posed.

This document follows EY's April 2014 report, 'Effectiveness of Australia's Financial Services Regulatory Settings', which was lodged by the Financial Services Council as part of the first round submissions to the Inquiry. In this report, EY outlined a number of recommendations covering Australia's banking, wealth management, superannuation and insurance industries.

These recommendations also considered market experience in five overseas jurisdictions: US, Canada, UK, HK and Singapore.

We believe the Inquiry's work is of significant national importance. We hope our submission is a useful contribution to the Committee's ongoing deliberations in this critical policy area.

Andrew Price
Managing Partner
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Growth and consolidation

Vertical Integration

Is the recent trend of greater vertical integration in the wealth management and superannuation sectors reducing competitive pressures and contributing to higher superannuation fees?

As noted by the Interim Report, Australia's retail financial services market is characterised by concentrated ownership and vertically integrated structures covering product manufacturing, advice and distribution related activities. However, we do not believe that vertical integration automatically leads to sub-optimal competition or consumer protection outcomes. Indeed, when operating efficiently, vertical integration models offer and can deliver a number of benefits, including:

- Diversification, scale, cost and pricing benefits, including as a result of cross-subsidisation
- Opportunities for highly tailored, customer-centric product and service delivery, including via strong co-ordination and collaboration between different business operations
- The backing of a strongly capitalised and regulated parent to stand behind obligations and promises made to consumers.

In fact, as noted, the retail banking sector has delivered a competitive (albeit concentrated) marketplace, with significant pricing, product and service delivery benefits enjoyed by consumers.

> "Customer satisfaction with the major banks has steadily increased since 2001 and is now at record highs, following an initial drop after the Wallis Inquiry. Consumers also have access to an extensive range of products and providers."
>
> *Financial System Inquiry Interim Report*

Both the Interim Report and the Grattan Institute question the current level of fees and operating charges in the superannuation market. However, we submit that such analysis needs to be contextualised with reference to differences in domestic and overseas market experience, as well as My Super and Super Streaming reforms, which are expected to deliver additional scale, competition and cost efficiencies to consumers.

In addition to superannuation, increasing globalisation and the development of alternative distribution channels in asset management (e.g. mFunds, passport regimes), technology driven portfolio, exchange and administrative solutions and further FoFA driven pricing impacts are all creating ongoing price and competitive tension — including with respect to platform and intermediary use. These initiatives should ultimately prove beneficial for end consumers.

Further, advice fee and service delivery pressure is also being driven by scaled and intrafund offerings, new technology providers and an intense focus on quality, conduct risk and regulator sanctions.

Are there mechanisms to ensure the efficiency of vertical integration flow through to consumers?

As noted, we see a range of factors and initiatives, both market and regulatory driven that will continue to drive efficiencies, innovation and high quality outcomes under vertically integrated models.

That said, clear challenges and priorities remain in ensuring vertically integrated models remain fit for purpose. Based on the above, we believe policy and regulatory responses to this issue need to be tactical, rather than structural. Specifically, they should be directed towards addressing business model and disclosure deficiencies that currently hamper conduct, culture, transparency and consumers' ability to genuinely vote with their feet.

A 'do nothing' approach based on current market dynamics is inappropriate. It would represent an opportunity lost to further improve the strength and standing of our financial services sector.

Mortgage brokers

Is vertical integration distorting the way in which mortgage brokers direct borrowers to lenders?

Vertical integration in the mortgage broking sector, particularly in the context of bank-owned aggregator channels has been the subject of significant industry debate. Approximately 47% of mortgages are distributed via the intermediated channel, with the majors' current market share of this business estimated to be in excess of 75%[1]. Changes to industry commission structures are currently being made; bank-led acquisition of stakes in mortgage aggregators continues as funding costs reduce and mortgage business ROE increases.

In this context, the potential for smaller lenders to be excluded from broker panels and artificial limits to be placed on consumer choice via remuneration conflicts and brokers preferencing in-house products has been questioned.

While acknowledging the market dominance of the majors, we submit this may be as much a function of market forces and business model advantages, as any limitations placed on product choice or incentives provided by parent-owned aggregators. Influencing factors include:

- Relative pricing power linked to scale, cost of funds advantages in particular implicit guarantees and favourable application of internal risk weights
- Superior service, platform, processing and product capabilities, which are in turn a function of scale and capacity to invest.

Although these scale, pricing and service advantages may strengthen the majors' market position in mortgage broking, we do not view this as automatically indicative of consumer detriment or market failure.

That said, there are arguments for enhanced management of potential conflicts through better risk management and disclosure practices. This could include providing more details regarding the volume of 'owner' mortgage products sold relative to other panel lenders and/or incentive arrangements between owners and aggregators.

The importance of these issues are magnified by broader industry dynamics applying to Australia's $1.3 trillion mortgage market.

Home ownership remains the single largest asset of most Australians, with lending fuelled by historically low interest rates, increasing property price growth (particularly in metropolitan areas) and equity redraw facilities. Standard mortgage loans, are also complemented by reverse mortgages, home equity lines of credit, interest only loans and lending in other sectors, including non-recourse borrowing by SMSFs. Retail investors being able to access the equity in their home to (aggressively) leverage investments also increases the potential for significant economic loss through the provision of poor financial advice. Clearly, significant market volatility may arise if disposable incomes and asset prices reduce, and/or unemployment and interest rates increase. Recent analyst reports point to repayment stress levels equivalent to GFC levels, where the cash rate increases by 100bps. [Credit Suisse analysis, June 2014].

In this context, although advice and service delivery are increasingly important, mortgage broking remains a fundamentally sales-driven industry, characterised by upfront commissions and ongoing trails of up to 60-70bps and 15-20bps respectively. Brokers are not remunerated in the absence of a mortgage product sale, which alongside other operating model features adds to potential risks.

These issues are discussed in further detail below.

If so, what would be the best way to limit the adverse impacts?

As noted, we do not agree that vertical integration is the main issue. However, there are adverse impacts associated with industry operation that require mitigation.

MFAA and FBAA Codes of Conduct, the National Consumer Credit Protection Act, responsible lending and 'not unsuitable' provisions have clearly improved practices and increased disclosure obligations for both brokers and lenders. That said, such standards do not equate to the introduction of best interests tests, conflict priority rules, or conflicted remuneration provisions under the FoFA measures.

1 Information from Mortgage & Finance Association of Australia

Greater consistency in regulatory standards and conflicts management should be considered, particularly given the likelihood of convergence between mortgage broking and financial planning industries. This does not mean the same regulations need to apply to both industries — to the contrary. However, functional consistency regarding the removal of key conflicts should be a major objective.

As noted above, this could be achieved via significantly improved disclosure arrangements around business model drivers. It may also extend to ensuring greater consistency or realignment of pricing and remuneration structures, including with respect to upfront commissions, ongoing trails and volume bonus arrangements. A fee for service requirement, whereby payments are made directly from the customer to the broker, as opposed from the product manufacturer, would largely mitigate this conflict.

As APRA recently noted in its Draft Prudential Guide on Mortgage Lending, *'experience has shown that commissions paid upfront tend to encourage less rigorous attention to loan application quality...'*

Clearly, any move to greater standardisation around industry pricing, remuneration and incentive structures would need to be evaluated from both a competition and consumer outcomes perspective. This includes imperatives to ensure business models are driven by product and service quality, rather than commission structures.

In addition to addressing conflicted remuneration practices, the practical realities of broker origination, credit application and approvals processes also bring challenges in terms of transparency, oversight and scrutiny of broker activities at the bank level. This is clearly an issue, given FSB principles that require underwriting practices of lenders to ensure responsible inquires have been made and viable lending has taken place.

In this regard, although lenders dictate loan application requirements, and industry clawback arrangements help deal with product churn, such measures do not deal with the adequacy of broker 'needs analysis', potential mortgage delinquency risk or conduct risk at the point of sale.

ASIC has pointed to increased action in recent times, including 42 bannings since January. Yet, cuts in regulator funding also raise questions about regulators' capacity to effectively and proactively supervise and monitor mortgage broking activity.

In an environment where interest rates are forecast to rise over the medium term, broker channel contribution to potential systemic exposures requires ongoing vigilance and stress testing. It also heightens the value of mitigating this increased risk through increasing broker competency levels, greater scrutiny around whether those entering the industry are 'fit and proper' and licensees taking more active steps to remove 'bad apples'.

In this context, the robustness of enterprise risk management models requires evaluation in light of licensee obligations and conditions, with further regulatory guidance needed. As raised in our first round submission to the Inquiry (lodged by the FSC), developing frameworks that better incorporate culture, leading risk indicators and mitigate conduct risk on a preventative basis are required across vertically integrated bank and wealth management channels.

This equally extends to mortgage broking channels and raises additional issues in terms of:

- Roles, accountabilities and capabilities with respect to risk and compliance functions
- Risk pricing, provisioning and adequacy of stress testing
- Upfront commissions versus ongoing trails, including linkage with mortgage delinquency and process failures
- Use of structured and unstructured data analytics to facilitate preventative controls
- Systems, training and reporting infrastructure at an institution, industry and regulator level.

These issues also need to be factored into regulatory approaches to a rapidly changing digital and technology driven environment and the need for compulsory credit reporting.

They should also be considered in light of revised capital charges applying to mortgages not backed by lenders mortgage insurance (LMI). In this context, if the majors effectively choose to self-insure and carry the risk of consumer default under such policy settings, there is further incentive to ensure overall market stability is not challenged by loan origination practices adopted via mortgage broking channels.

Funding

What are the impediments to the development of liquid, tradeable claims on infrastructure projects?

The illiquidity of direct infrastructure investment makes it less attractive to superannuation fund investors, because employees are currently able to switch funds with just three days' notice. This means funds need to hold a high proportion of funds in liquid investments, so they can readily transfer employee investment balances as directed.

Fund reluctance to invest in illiquid infrastructure assets could potentially be reduced by modifying the portability requirement to give funds a more reasonable timeframe within which to make account transfers. This would also reduce the need for APRA to focus on regulating fund liquidity.

If the portability requirement cannot be amended, then alternative infrastructure investment instruments could be developed. To encourage this market, the following elements will be required on both the supply and demand sides:

Supply side
A liquid derivative market requires a large and homogenous physical market against which derivatives can be written and traded. The current portfolio of privately-owned infrastructure projects with equivalent financial characteristics is unlikely to be large enough to support an efficient derivative market.

Government project sponsors can encourage market development by increasing the volume of projects brought to market and further standardising their commercial parameters. The Commonwealth can play an important role in this process through:

- Accelerating the development of infrastructure by expanding the funding and financing support it provides to State projects.
- Encouraging further consistency in the commercial structure of State projects through Infrastructure Australia guidelines on projects to be included in the Infrastructure Priority List.

Demand side
Direct investment in infrastructure projects requires substantial specialist assessment and management skills yet, given the liquidity constraints, SMSF and smaller funds are currently unlikely to have such teams. Stimulating demand from these smaller investors will require an active education process. This should articulate the advantages of investing in infrastructure and how the new instruments provide an efficient and regulatory-compliant conduit into this type of investment.

Funds that currently hold direct infrastructure investments will only participate in a derivative market if they believe they can generate value for fund members. This requires them to have confidence there will be a sufficiently large and sophisticated set of potential buyers to warrant the expense and risk involved in structuring this type of instrument.

That said, we are of the view that the lack of development of derivative instruments in infrastructure projects is not indicative of a "market failure" requiring Government intervention. A sufficient pool of local and global funds already exists to manage the liquidity risk of direct infrastructure investment, without the need to lay this risk off via secondary market structures.

EY sees evidence of increased interest in the private placement lending market. For example, a 2014 EY survey with CFOs identified that 20% of respondents were interested in funding in the Australian domestic private placement market. This market is seen as a valuable alternative to the bank, bond and US private placement markets, providing further diversity/options, longer tenors, AUD funding (as opposed to USD) and more flexible terms.

Equally, since 2008, we have seen more than 20 loan market transactions in the syndicated loan market with participation from superannuation investors, mostly in the investment grade and infrastructure sectors. In addition, these same investors have made numerous private loan transactions in infrastructure, property and private equity. As a result, the Australian private placement lending market has increased substantially, now standing at $13.6bn (ABS). Market participants include Metrics Credit, Westbourne Capital, IFM, AMP, Challenger, and Hastings Funds Management — funded by various Australian based retail and industry superannuation funds.

We are also currently completing two transactions in this area: one senior debt loan to a client in the equipment hire sector, where the banks are reluctant to lend; and a senior debt/mezzanine loan on a commercial office building. We also have a pipeline of interested corporate clients looking to explore this area.

Encouraging the development of this market would also:

- Supplement the +$1bn syndicated loan transactions, which is critical to the infrastructure sector
- Fund M&A in sectors less favoured by the major banks, where many recent deals have been to Private Equity
- Open up avenues for second tier lenders/regional banks to raise funding, which is then on lent to SMEs.

How can the supply of capital to this market be enhanced?

At the end of 2013, Australia had $1.7 trillion in funds under management[2], which is expected to double to over $3.5 trillion by 2029[3].

In relation to other OECD nations, Australia has the second lowest allocation to fixed interest securities (Source: Access Deloitte Maximising Superannuation Capital). Currently, Australian superannuation funds allocate approximately 5.6% into debt products, and 40.7% in equity (Source: ABS). Whereas, the OECD average is approximately 53% in debt products, 20% in equity, 12% in cash and 15% in other investment vehicles.

General and life insurers in Australia have around $290bn in investments, with some allocated to corporate bonds but none to illiquid loans or private placements. APRA requires these insurers to invest in a prescribed level of investment grade, liquid corporate bonds, with restrictions on any unrated and/or sub-investment grade loans.

From a risk perspective, growing the bond market would also be a positive. Increased investment in the senior secured debt part of the capital structure, as opposed to the equity component, would mitigate risk in significant market fluctuations. In addition, encouraging this investment via the superannuation and insurance industries would mean investment decisions being made by professional, rather than retail investors. It would also offer the benefit of diversification, should there be any losses/problems on any specific debt securities.

This market could be further enhanced by:

- **Government legislated change in fund allocations** – increasing debt allocations by just 2% p.a. over three years would add more than $100bn in funds able to be invested in debt securities (bonds, loans and/or commercial paper). The market would evolve to support this requirement, with many funds already establishing experienced credit/loans teams, and would also support the corporate bond market. Given the small shift, equity markets would not be disadvantaged. The extra liquidity available would allow public corporate borrowers to use the lower cost funds for growth/expansion.
- **Liquidity and pricing** – illiquid securities (i.e. loans) could be valued on a hold to maturity basis, with independent reviews as required. Active interference would be limited, as the greater market size would see increased trading/pricing of illiquid securities in a more active secondary market. Although quarterly performance reporting would remain an issue, since all funds would be working off a common base, due to the mandated level of debt securities, all performance reporting should be on a like-for-like basis.
- **A simplified, cost effective rating system** (similar to the NAIC for US placements) – Australia could implement a simple, off market and confidential rating system recognised by superannuation funds, insurance companies as well as government regulatory bodies. Alternatively, loans could be rated internally, with an external independent review, to support both the superannuation and insurance investment market.
- **Reducing APRA's restrictions on insurers' investments in debt securities** – allowing insurers to also invest in illiquid securities would open up a new pool of capital. This could also involve APRA gaining comfort from the proposed rating system/external independent reviews above.

2 ABS
3 Rice Warner

Consumer Outcomes

Financial advice, technology and consumer protection

EY previously lodged a first round submission, via the Financial Services Council, covering a range of financial advice and related recommendations. Such measures included enhanced risk management and disclosure models, product suitability, more targeted regulator powers, increased education standards, tax deductibility of personal advice and financial literacy initiatives. (Please refer to EY's April 2014 report, **'Effectiveness of Australia's Financial Services Regulatory Settings'**, which was lodged by the Financial Services Council as part of the first round submissions to the Inquiry).

What opportunities exist for enhancing consumer access to low-cost, effective advice? What opportunities are there for using technology to deliver advice services and what are the regulatory impediments, if any, to those being realised?

We agree that opportunities exist for technological disruption to deliver more efficient, lower cost advisory services to consumers. This is particularly the case with respect to investment portfolio, insurance and other 'simpler' advisory solutions.

Such models are being actively pursued in a range of international markets. For example, in the US the likes of Wealth Front, Betterment, Personal Capital are becoming more prominent, although consumer take-up is still nascent. Domestically, an increasing range of technology led solutions are being provided by, for example, Provisio, Iress / XPlan, Midwinter, MOVO.

What are the potential costs or risks of this form of financial advice, and what measures could be taken to mitigate any risks?

Although scaled, intrafund and technology-driven offerings are important for broadening access to advice, any limitations associated with such offerings, including assumptions on which modelling and advice is based, need to be transparently disclosed to ensure consumers are not misled regarding capabilities or the comprehensiveness of solutions delivered.

ASIC research[4] demonstrates consumers' inability to determine whether advice is good, bad or otherwise. This highlights the need for enhanced enterprise risk management and regulatory approaches to properly address these risks, as well as behavioural and other financial literacy issues. For example, disclosure mechanisms must be effective and transparent, if consumers are to be empowered to make good product and service choices consistent with their needs.

There is a risk that demand for fast, low-cost advice will dilute advice quality. It could also entrench consumer misunderstandings around the value of good quality personal advice and the skillsets, infrastructure and capabilities required to deliver it.

Delivering high quality, personal, holistic advice in Australia is not easy or cheap. It often requires specialist investment, tax and legal knowledge, backed by strong client communication and management skills. Significant infrastructure is required to support service delivery compliance.

To this point, the FoFA provisions have been heavily debated and requirements for increased education and competency standards are well documented. However, the policy elephant in the room remains the economic model of some traditional advice businesses, where the real cost of advice is heavily cross-subsidised by incentivised product sales.

In this context, ownership / vertical integration structures are not the problem so much as:

- Inadequate transparency and disclosure to consumers of the main drivers of some adviser business models, particularly where cross-subsidisation and requirements to sell in-house products unduly influence business profitability and valuation
- Business model features that potentially distort the independence of advice delivery, product selection and service offerings. These include remuneration or incentive structures, APL design and execution, the way advice is priced and KPIs regarding internal product sales

4 ASIC Report 279: Shadow shopping study of retirement advice – March 2012

- Consumers with limited appreciation of potential conflicts, differing business models or the value of advice, especially in terms of it delivering financial wellbeing or peace of mind. This has arguably been driven by decades old industry approaches, which have devalued advice by offering it as a loss leader into a product sale. This has resulted in technical capabilities and skills required to deliver high quality advice being undervalued relative to sales capabilities. As a result, the value proposition associated with a highly skilled, well-educated adviser delivering a technically proficient and robust advice has not been well articulated or understood.

As industry under FoFA seeks to 'turn this ship in the harbour', business model, risk and communication challenges exist in creating, scalable high quality advice models that:

- Are appropriately valued by consumers and elicit broader based market take up
- Continue to offer product solutions, but in a fashion that ensures advice is unbundled from product distribution in both form and substance and does not operate as a loss leader into the transaction.

Part of the answer revolves around technology-enabled, low-cost, scaled and intrafund advice solutions being delivered to a broader base of consumers. EY also believes technology has a vital role to play in delivering more sophisticated, personal advisory services at lower marginal cost.

The solution also requires a sustainable industry model, where personal advice pricing moves beyond heavy cross-subsidisation and more accurately reflects the value provided and the marginal cost of production. However, if consumers fail to recognise the value of advice, this represents a barrier to transforming advice business models in a way that promotes accelerated development of scalable, sustainable and high quality advice solutions.

These issues, along with the recommendations we have previously outlined, are not currently addressed and require urgent attention from policy makers, industry and regulators.

Is there is a case to more clearly distinguish between independent and aligned advisers, and what options exist for doing this?

The above question implies that 'aligned' advisers deliver substantively different, and potentially inferior, services to 'independent' advisers, due to differing ownership structures. We believe this starting premise is difficult to support.

In this regard, we don't believe that vertically integrated ownership structures automatically impair the quality of advice provided to consumers. Our experience reveals numerous examples of high quality advice being delivered to consumers by high quality financial advisers operating under 'aligned' business models.

In our view, business model attributes, such as remuneration and incentive arrangements, APL design and implementation, advice processes and supporting infrastructure, training and enterprise risk management systems, are more important lead indicators of advice quality than underlying ownership arrangements.

In this context, we believe that to draw distinctions between different types of financial advisers on the basis of ownership structures alone, would potentially be misleading and unhelpful to consumers.

Would consumers be likely to understand the difference between aligned and independent advisers and, if so, to what extent would this be likely to factor into a consumer's decision to take the advice?

As noted, we believe the case to more clearly distinguish between advisers on the basis of ownership structures is in our view problematic.

If distinctions are to be drawn, we believe attention should first be directed towards better defining the skills, education and service delivery capabilities of the approximately 51,000 people licensed to provide financial product advice in Australia. In particular, use of the descriptors 'financial adviser', 'financial planner' or like terms should be limited to those who are members of professional bodies, suitably skilled, educated and qualified to provide personal advice. Such information should be disclosed in public registers, disclosure and other marketing materials in line with existing compliance obligations. We note similar policy initiatives are being pursued in other countries.

Such disclosure improvements will improve transparency and increase consumer understanding of, and trust in, the value of personal advice delivered by appropriately qualified professionals.

If further distinctions are to be drawn along the lines of the UK ‘restricted vs independent adviser’ model, then as noted above we believe it is critical to consider what classifications are going to be used and how they should be defined, including with reference to the business model attributes outlined.

Would consumers be likely to be sensitive to differences in the price of independent or aligned advice?

Advisor (and hence advice) classification differences are particularly important, given potentially material impacts for consumer demand, pricing, business model valuation and employment. The sensitivity of clients to these impacts is difficult to gauge and would be influenced by a range of factors, including current industry demographics, market scrutiny, relative pricing impacts under such a model and changing competitive landscape. Robust cost-benefit analysis of any proposed changes should be undertaken prior to implementation, including with reference to international market experience.

Retirement Income

Response to preliminary assessment — Retirement Income

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

1. *Maintain the status quo with improved provision of financial advice and removal of impediments to product development*
2. *Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks*
3. *Introduce a default option for how individuals take their retirement benefits*
4. *Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).*

EY acknowledges that improving the provision of pre-retirement financial advice and removing barriers to developing new income products are important. However, we do not believe these actions alone are enough to address the income and risk management needs of retirees. In addition, specific education is required for the broader populous, and particularly the financial advice market, about the importance of retirement income planning, including post-retirement needs profiles and risk-return profiles over the longer term.

We agree that policy incentives should be introduced to encourage the take-up of retirement income products that help manage longevity and other risks. This will help to transfer these risks from the public to the private sector.

It would also be beneficial to continue the accumulation phase's mandatory deferral of consumption, as the current regime effectively allows this to be undone by the accumulation of debt, which can be paid off by (and absorb) accumulated wealth.

We believe the benefit of default and/or mandated products would be limited, since every retiree would have their own risk and income-need profiles. This would make it difficult to find one-size-fits-all solutions.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

1. *No change to current arrangements*
2. *Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-tests*
3. *For product providers, streamline administrative arrangements for assessing the eligibility for tax concessions and Age Pension means-tests treatment of retirement income products*
4. *Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products.*

We do not believe that the status-quo ("no change to current arrangements") is sustainable.

At present, regulated minimum limits are imposed on the level of income provided to retirees — stifling product design. This is just one example of multiple regulatory and legislative requirements that create an unnecessary barrier to entry and complexity for retirement income product providers — both through the increased workload from separate requirements and, in some cases, from conflicting requirements. Such a barrier to entry will reduce choice and value for consumers. Also, the complexity introduced by these requirements can lead to customers not understanding the products and, in turn, financial advisers having difficulty selling them.

We therefore believe that elements of response 2 and 3 are warranted. This may not necessarily require moving from codified to principals-based rules, or streamlining administrative arrangements. Instead, it might be satisfied by moving to one set of simplified rules that serves the purposes of the existing requirements.

The downside to a principles-based approach is a lack of certainty around which products would be eligible for tax concessions. For this approach to work in practice, we believe a regulatory body (or equivalent) would need to provide product rulings (or equivalent) on a sign-off basis, in a way that does not add too much impost on product providers.

We believe the issuance of longer dated government bonds, both nominal and index linked, will support the development and competitive pricing of annuity products in particular. Without a deep market in long-dated, fixed-interest or index-linked instruments, the provision of annuities will continue to present a reinvestment risk to the provider. The presence of this risk effectively acts to drive up prices to retirees, so their annuity premium results in less income received. This reinvestment risk becomes more profound when considering deferred lifetime annuities, as they possess longer durations than term and immediate lifetime annuities.

We also note that a greater supply of such instruments may, all other things equal, act to increase the yield of long-dated instruments and improve the pricing of annuities.

Would deferred lifetime annuities or group self-annuitisation be useful products for Australian retirees? Are there examples of other potentially suitable products?

Deferred lifetime annuities have many potential benefits, including the ability to facilitate the transfer of longevity risk from the public to the private sector. One issue with deferred lifetime annuities in low interest rate environments is that the annual payments can be quite small — particularly for the average Australian's superannuation balance at retirement. This can be negated to some extent by an increased deferment period; however, the perceived attractiveness of lengthy deferment periods is very low in an Australian market that is yet to fully embrace immediate lifetime annuities. Another alternative is for Government to partially subsidise the private sector by providing longevity insurance. This would simultaneously reduce the capital requirements of life insurers, which can be quite large for deferred lifetime annuities, and increase annuity rates.

Group self-annuitisation
In practice, this idea has some issues. Notably:

- **Longevity risk is not totally eliminated.** If a given group of members live longer than expected, the pool of funds will be depleted prematurely. Even if adjustments to the income rate are made to prolong the life of the pool of funds, the income reductions have the potential to be large enough to significantly reduce the longevity risk protection. So, the argument about not requiring any capital is a weak one, as the cost of not putting up capital is the lack of a guarantee around longevity risk protection.
- **Administration costs can be significant** as the returns and mortality experience need to be regularly monitored and income levels adjusted, so scale is important.

We strongly believe that a portfolio of income solutions (i.e. hybrids of individual products) is the most suitable approach to meet retiree needs. At a crude level, account-based pensions provide the most flexibility and inheritance potential at the expense of market and longevity risk. However, annuities, while protecting against market and longevity risk, do not offer the same degree of flexibility in their current forms. Therefore, we believe the best solution lies somewhere in between.

Given the current extent of residential assets as a proportion of total individual wealth, there may also be room for equity-release products to be bundled into a portfolio of income solutions, to further increase either flexibility, or market and longevity protection, or both.

If part of retirees' superannuation benefits were to default into an income stream product, which product(s) would be appropriate?

Different investors/retirees have different risk and income-need profiles, making it difficult to specify any one particular product suitable for everyone. When contemplating default income stream products, we believe the following features should be considered:

- A mandatory minimum level of deferral of consumption. This can be achieved in several ways, including mandated partial annuitisation or having maximum drawdown amounts.
- Clear and easily-accessed portability between product providers to facilitate a competitive market.
- Consumer protection around defaults, as it could be easy for unscrupulous product providers to present defaults with poor financial terms and rely on poorly informed customers not comparing alternatives — as seen, to some extent, in the UK market.

Will the private sector be able to manage longevity risk if there is a large increase in the use of longevity-protected products? How could this be achieved?

We believe the private sector will be able to manage the longevity risk from a large increase in the use of longevity-protected products, as long as:

- There is access to global longevity insurance markets particularly for tail risks. This will require the lowering of barriers to global risk transfer and aligning regulatory restrictions.
- Any large increase in the use of these products is on commercial terms. As discussed, this could be achieved with Government subsidies or incentives to manage tail risk.

Should Government increase its provision of longevity insurance? How would institutional arrangements be established to ensure they were stable and not subject to political interference?

Given Australia's demographics, we do not believe the Federal Government should be seeking to increase its net provision of longevity insurance. We believe transferring longevity risk from the public to the private sector is critical to the sustainability of the retirement income system.

As an alternative, the Government could provide longevity insurance as a means of supplementing private sector products, which would take pressure off the Age Pension. Similarly, Government could subsidise longevity insurance providers, either directly by subsidising annuity product rates or by issuing cheap longevity bonds. We believe both approaches should only be considered if the net impact reduces the potential long-term cost to the Government.

Government has several reasons to assist the private sector in this way, including the possibility that the concentration risk of tail longevity may become too great for capital markets to bear. Also, retirees with small balances may not be well served by the private sector. Given these retirees would often draw the maximum Age Pension, it may be in the Government's best interest to assist the private sector with offering attractive incomes for this cohort.

What are some appropriate ways to assess and compare retirement income products? Is 'income efficiency' a useful measure?

The nature of retirement income products means that no single measure accurately compares the suitability of one product to another. Ultimately, it will depend on the individual and their preferences and needs. When weighing up retirement income products, the following elements should be considered:

- Expected total value received, including all sources of income (net present value). As opposed to income efficiency, which only values the product itself, we believe this measure should also include the value of the Age Pension and any other social security benefits. This allows accurate comparisons between products, taking into account an individual's income entitlements from all sources.
- Riskiness of income payments and account balance movements, often measured via the size of the range of possible income and account balance outcomes.
- Desired income attainability, which can be measured as the ratio of expected income to desired income measured every year up to the retiree's expected life – or longer.
- Inheritance value – if relevant.

The degree to which one consideration is deemed more important than another depends on the individual. So, a reasonable approach to compare products would be to present all four metrics and discuss with the retiree what is important to them. In our experience, it is rare that any one product will perform the strongest across all four metrics.

What, if any, regulations impede the development of products to help retirees access the equity in their homes?

Making the family home exempt from the Age Pension Assets Test reduces the incentive to transform the equity in the home to an income stream, distorting asset allocations towards the home at the expense of a potentially more balanced portfolio. Conversely, if this exemption no longer applied, it would encourage equity-release products to be taken up.

However, retirees should not be forced into a situation where they must leave their home as a result of removing this exemption. One way to overcome this is to develop products where the underwriter bears the longevity risk, thus allowing the retiree to live in their home for the rest of their life, or until they require aged care. To make a product like this more attractive to underwriters, the Government may wish to investigate the benefit of accepting some of this longevity risk.

Relative to the decrease in Age Pension cost that this change would cause, this bearing of longevity risk should be sustainable, if set up correctly.

Removing this exemption also has the potential to increase demand for equity-release products. In general, if regulatory changes encourage the growth of the market, we suggest additional scrutiny on the products and sales and advice process to promote good outcomes for retirees.

If the family home was to be exempt from the Age Pension Assets Test, then this would also encourage down-sizing. However, Stamp Duty would act as an impediment to this and should be reviewed in this context. Stamp Duty friction aside, down-sizing could lead to an increase in property supply, with the potential to depress property values.

Overall, we believe the impact of any regulatory change has the potential to be complex and affect multiple facets of the economy. We encourage detailed modelling of the various impacts before committing to the change.

Regulatory Architecture

The Inquiry seeks further information on a number of areas related to regulatory architecture. Our first round submission included our recommendations more broadly. This submission provides information and our point of view in relation to certain specific points.

Costs and benefits of regulation

Is there evidence to support the conclusions that the regulatory burden is relatively high in Australia when considered against comparable jurisdictions? Are there examples where it can be demonstrated that the costs of regulation affecting the financial system are outweighing the benefits?

The Inquiry has engaged EY to assist in better understanding the cost benefit of regulation, including quantitative modelling with case studies of the introduction new or changes to financial services regulation.

We look forward to completing that work and its results feeding into the Inquiry.

Budgetary independence of regulators

Move ASIC and APRA to a more autonomous budget and funding process?

EY supports exploring industry funding models for ASIC and APRA.

This would enable a more stable funding base for the financial services regulators, which in turn would enable greater stability for the regulatory agencies, provide a basis for delivering against longer-term regulatory goals, and, importantly, create a greater degree of certainty and consistency for the financial system and its users. A more explicit separation of funding would also minimise any perception of a conflict of interest between the government of the day and regulators.

More autonomous funding processes have been developed and adopted in comparable overseas jurisdictions, including the UK, Canada and Hong Kong.

Accountability of regulators

Clarify the metrics for assessing regulatory performance?

EY supports the development of clear, unambiguous and measurable metrics to assess regulatory performance.

A number of existing governance, oversight and transparency arrangements already hold the financial services regulators to account. For example, Senate Estimates, Parliamentary Joint Committees, annual performance and statutory reporting.

Consistent with a more autonomous budget and funding model, would be the expectation of improved metrics against which the regulator would measure itself and be accountable to these oversight forums. We would encourage these metrics to have a bias towards measuring outcomes rather than outputs. We also believe this would be an appropriate mechanism to measure any competition mandate consideration should that be a recommendation for ASIC.

Regulator structure and coordination

Increase the Council of Financial Regulators (CFR) membership to include ACCC, AUSTRAC and the ATO? Increase the reporting by the CFR?

EY supports the inclusion of ACCC, AUSTRAC and ATO in the membership of the CFR.

The CFR has a valuable coordination role across the regulation of the financial system. The Inquiry recognises the increasing interconnectedness of the financial system and interrelationships between the data, reporting and conduct of participants, users and regulators. The added dimension of global markets and regulators is also a strong basis for increasing the CFR membership to include agencies with interconnectedness with overseas regulators. For example global AML/CTF regulators.

EY supports better reporting by the CFR.

The CFR has a significant opportunity to improve transparency about its focus and activity of regulators on areas of current, future and emerging focus. Although individual regulators and central banks use this type of reporting to send strong market signals in their specific mandate and market, the collective CFR view would produce a clearer and more effective lever to identify and address the most significant issues in the financial system.

The CFR should consider annual reports on the year ahead, regular reports following each meeting to communicate key issues and any adjustments, and reporting back at the end of each year to demonstrate accountability and outcomes. A longer-range, 'over the horizon' view would also be valuable to the market and could align to the CFR members' strategic regulatory plans.

Taxation

Stability

We support the approach of any tax-related issues being properly considered by the Government in other ways, such as part of the White Paper Review into the Tax System. We note that some of the tax issues raised in the Interim Report, for example the questions regarding the need for the dividend imputation system, have caused alarm in Australia's capital markets. Such alarm, at a time when the global economy is still recovering from the Global Financial Crisis, is not desirable in preserving and confirming the stability of Australia's Tax System. Additionally, not all of the tax-related issues identified require action in the near term.

We also recommend very close and ongoing coordination between the White Paper Review and the Inquiry, to ensure the Inquiry's recommendations properly identify and address the relevant tax implications in a holistic manner. We believe this will be critical to the successful implementation of any recommendations.

International integration

We commend the Government's efforts to promote Australia's policy interests on international standard setting and refer the Inquiry to the comments in our recent report on the Asian Region Funds Passport. In addition, specific taxation issues need to be addressed to ensure success.

From an Australian perspective, given our large superannuation asset pool and sophisticated funds management industry, there should be significant benefits from the Asia Region Funds Passport. Australia has the skills, infrastructure and regulatory frameworks to be a very active participant in this initiative. Asian investors would be attracted to the high quality products generated by the large pool of assets and diverse asset classes currently managed in Australia. Equally, the opportunity for Australian investors to seamlessly invest in ex-Australia product can only be positive from a diversification and competition perspective. It should result in more assets under management locally, creating more employment opportunities for a skilled Australian work place.

However, the Australian tax framework is challenging in its complexity and reach. Clarity will be required as to the tax consequences of Australians investing offshore and equally Asian residents investing into Australia. We often hear foreign investors expressing concern over the lack of certainty of tax outcomes in an Australian context. Such concerns must be addressed for Australia to fully benefit from this important initiative.

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