FINANCIAL SYSTEM INQUIRY 2014

Response to the Financial Services Inquiry Interim Report

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Financial Institutions & Markets Advisory (***FIMA***) is pleased to submit these comments on the 2014 Financial Services Inquiry (***Inquiry*** *or* ***FSI***) Interim Report. FIMA's practitioner experience and multi-disciplinary skill set encompasses hands-on knowledge of banks and other financial institutions across global financial markets. We understand their prevalent culture and behaviour, strategic imperatives and goals, rules of the game in terms of governance and oversight, risk appetite and risk/reward protocols, incentive and performance measurement drivers and capital management tools. Our experience encompasses an informed, proactive capacity to assess the governance and oversight standards underpinning financial systems, the purpose and interests of governments, institutions (both private and public) and their representatives, their policy objectives and guiding principles. As such we hope the practical comments below are constructive to the progress of the final report.

A. OVERVIEW

A case for complacency based on the global financial crisis (***GFC***) experience does not stack up. Australian banks' capital bases, balance sheets, and liquidity and funding profiles were at best equivalent to offshore peers and in some instances worse. For example, several major Canadian banks funded their retail funding gap via long term debt v short term money market instruments while maintaining an equivalent credit risk profile v their Australian counterparts. The GFC has been extensively researched and documented, and FIMA acknowledges the leadership role played by the Central Bank in quickly appreciating the severity of the crisis and responding with creative risk mitigation initiatives, particularly in the Funding and Liquidity arena. In our view the major differentiator for Australian banks compared to those offshore, was a benign credit risk profile, enabled via government funding support and elevated rewards, which inhibited a replication of the offshore bank management culture and behaviour to write increasingly high risk business, at an ongoing cost for customers and taxpayers.

FIMA recognises the subsequent initiatives to enhance the resilience of bank 's balance sheets, particularly in relation to capital and liquidity , within a system where the core structural fundamentals remain substantively unchanged – eg dependency on offshore financing, leverage via bank balance sheet risk profile of the residential housing market, Big 4 concentration and dominance of the banking markets, intermediation of Superfunds and fiduciary responsibilities for savings and deposits away from the banking system, underperforming domestic corporate and retail bond markets.

FIMA, therefore, is less sanguine than the Inquiry as to the starting point in calibrating the severity of the impact of the GFC on the Australian financial system, the readiness and effectiveness of the regulatory response, lessons learnt and their adoption in providing future direction. For example, the Bank for International Settlements (***BIS***) estimated there was a $95bn exchange rate adjusted reduction in Australian banks' net external liabilities in the latter half of 2008, due to repatriation of USD.

Key Principles

P1 Financial system governance, compliance and oversight settings are credible, robust and responsive in directing practices and behaviours to maintain and develop the reputation, performance and trust of financial markets.

P2 Financial system settings are subject to a cost / benefit discipline to accommodate the tradeoffs between stakeholders and deliver a balanced outcome in the national interest.

P3 Regulatory framework is to be resilient to respond to and counter systemic instability events within predefined contingency planning protocols, risk appetite settings and confidence levels.

Recommendations

R1 A regulatory contingency planning capability to be in place, with the required modelling, simulation and stress test tools across the financial system, to evidence the capacity to manage systemic instability events, subject to 3 yearly independent review and reporting to the Commonwealth Treasurer.

R2 Skills within the Commonwealth Treasury to be upgraded to undertake a leadership role with APRA, RBA, ASIC and ACCC in the national interest rather than the current "hand holding role" with individual public policy stakeholders and their agendas.

B. UNAMBITIOUS AND EVOLUTIONARY

The Inquiry's terms of reference, announced on 20 December 2013, articulated a forward looking agenda, recognising the ever accelerating pace of innovation impacting the financial services sector, while appraising the consequences of developments since the 1997 Financial System Inquiry.

FIMA had anticipated, in the context of the c.15 year intervals between inquiries, that the Inquiry would develop a perspective on the future financial services landscape, potentially via deploying scenario planning tools, as a precursor to refreshing the philosophy, principles and objectives underpinning a well-functioning financial system.

FIMA acknowledge the short timeframes for the Inquiry and the potential for this to be a candidate for the "too hard" category. However, a financial system inquiry has been on the radar since 2012 and FIMA has direct experience of non-interest in scenario planning tools by specific public policy stakeholders. Regulators, like everyone else, can't direct the past or the present, only the future - "scenarios provide perspectives on the future to direct and execute insightful strategies today."

The landscape in 2025-30 will be unrecognisable from today:

- "Virtual Banking" will be the reality;
- customer ownership will be a battleground for telcos, banks, software and card giants;

- vertical enterprises embracing media, marketing, central servicers, financiers and banks will proliferate;
- demographics will dictate that households will move from an accumulation to a decumulation phase;
- technology will be the driving force for outperformance; and
- the development of bespoke banking and differentiated pricing will aggravate current severe social disparities in financial services offerings and access.

These perspectives, portending a fragmentation of the sector, will present significant challenges to public policy stakeholders.

FIMA appreciates that global principles and standards await discussion and endorsement at the upcoming G20 meeting, with this Inquiry a major contributor to the stance by the Australian Government. However, while the interim report appropriately references macro-economic factors such as interest rates, it takes little account of these perspectives. As a consequence, it is unambitious, evolutionary rather than revolutionary, and resonant of preserving the status quo rather than presenting a robust public policy framework for the next 10-15 years.

The Inquiry is also to spend considerable time in the period between its Interim Report and consideration of follow up submissions visiting and assessing offshore public policy frameworks and their lessons and relevance for Australia. FIMA particularly emphasises the Canadian financial system as an exemplar, with its credentials as being the most congruent, best practice and systemically resilient of offshore financial services frameworks when compared to its Australian counterpart

Key Principles

P4 Financial systems settings, principles and objectives are to be forward looking to incorporate a future perspective on the financial services landscape consistent with a strategic relevance and application.

Recommendations

R2 Follow up, or future commissioning of Inquiries, to accommodate a major role and exercise for forward scenario planning and tools to set a perspective for the future landscape and the relevance of the identified strategic options.

R3 Existing modelling and simulation of the financial system to be complemented by deployment of scenario planning tools and methodologies to empower a forward looking policy stance on digital and virtual banking innovations rather than waiting for them to happen.

C. POLICY THEMES AND INTERIM CONCLUSIONS

Competitive, but Concentrated

The submissions of Treasury, RBA and, less so, APRA indicate an opening stance that competitive equilibrium is alive and well in the Australian financial system. For example the RBA submission specifically remarks that “it is widely agreed that indicators of market structure, such as market concentration, do not measure competition." The references quoted therein suggest this is overstated ie the OECD report actually states "concentration, among other structures, is not a good proxy for competition". Scale on a standalone basis does not define competitive equilibrium but it does facilitate the opportunity for competitive disequilibrium.

The submissions also reiterate other determinants such as declining net interest margins and stable commission rates. However a more comprehensive, commercial assessment approach would recognise that:

- ROE returns for the Big 4 banks are highly elevated at 14-18%;
- Big 4 bank equity valuations for a 22 million population are globally among the highest; and
- the Big 4 banks are making these returns while being global forerunners in complying with onerous Basel III implementation requirements.

Margins and fees may be stabilising, but a commercial "Big 4" strategy of pocketing significant technology and media innovation gains rather than transmission to customers, plus a benign provisioning environment and implicit government support, underwrites ongoing highly elevated ROE targets and a competitive disequilibrium. The Big 4 banks also currently comply with stress test insolvency criteria at 99.95% confidence levels which is compatible with a neo-utility risk profile, not 14-18% ROE targets.

Post a more objective and comprehensive determinants process, effective strategic options to level the competitive playing field are at best challenging. Previous policy initiatives have delivered adverse competitive outcomes (eg ATM fees). The 4 Pillars policy, coupled with equity valuations, inflated book values and a 22 million population, effectively rule out any offshore incursion. Many taxpayers have core investment holdings in the Big 4 banks, while they pay significant corporate taxes and directly employ around 150, 000 people.

However, Australian business and commerce cannot continue to incur capital and financing costs premised on excessive ROEs that run into $5-10bper annum. In the event public policy stakeholders continue to maintain that competition in financial services is alive and well in Australia, they should refer to outcomes in Canada, where customer surveys represent a 90% rating for choice alternatives, with 4 million customers switching in a 5 year period and fees and commissions at levels unavailable in Australia – a brave New World that Australia seems reluctant to enter.

Key Principles

P5 Balancing competition and stability agendas, there is to be a disposition in favour of competition unless there are compelling cost / benefit outcomes to the contrary;

P6 Refer P2 re a compulsory cost / benefit discipline;

P7 Financial markets' competition is to be subject to the same holistic, regulatory governance, compliance and oversight process as other sectors of the economy.

Recommendations

R4 Introduction of a Recovery & Reference framework (referenced below) will be a significant step towards competitive neutrality;

R5 Transferring banking relationships should be as simple as a “click”, facilitated by a direct debit clearing house funded by the banks, and mobility of products;

R6 Services and product offerings should be available to customers based on risk profiles, pricing and suitability, not the existing tenure with the banks, and advertised in all distribution channels;

R7 Annual statements of fees and commissions to be forwarded to customers, with 2 years of history;

R8 An early, informed stance to be developed to promote competition from innovation in technology, media and communications;

R9 The competition enquiry currently in train is to embrace a much more intensive, comprehensive assessment and conclusion process than the public policy stakeholder submissions to the Inquiry.

Too Big to Fail

FIMA believes this is “the dog that didn’t bark in the night” in assessing the policy stance and adoption of a Recovery and Resolution (R&R) framework for the Australian financial system. The Bank of England has recently introduced its final Consultancy Paper to position for the introduction of an R&R framework for UK regulated entities as of January 1, 2015, with the European Union following a similar timetable – in the US, Dodd-Frank is inevitably following a slower timetable, given the lobbying strength of its banks and the political impasse in Congress.

In Australia, while “living wills” have been submitted by the banks, and APRA has prescribed a 1% incremental CET ratio for domestic SIBS, the commitment, direction and timetable for R&R remains unknown. This in marked contrast to Canada – the Canadian Bankers Association (***CBA***), as early as 2011, confirmed its support for the principles underpinning R&R, in marked contrast to their Australian counterparts, who have issued no such commitment.

The International Monetary Fund (***IMF***) has embraced the Financial Stability Board (***FSB***) principles and promoted their adoption and the implementation of the enabling structures on a global basis. It has done so on the basis of the compelling benefits it delivers in terms of governance, accountability, transparency and behaviour outcomes – i.e. constrains contagion risk, minimises taxpayer moral hazard, addresses conflicts of interest within the financial system, incentivises enhanced investor assessment, management appetite and corporate culture for risk, and represents a major step towards competitive equilibrium and, therefore, underpins systemic stability. There is authoritative research by bodies such as the Organisation for Economic Co-operation and Development (***OECD***), IMF, the Basel Committee on Banking Supervision and the FSB, confirming that systemic instability evidenced in the financial markets during the GCF resulted in GDP declines over the first 12-15 months of 4-5%, resulting in $10Bns of cost impact for major economies, as opposed to an R&R implementation cost estimated at around $1-3 Bn.

Key Principles

P8 A complex R&R framework can be simply defined and designed via 5-6 principles for banks:

P8.1 Maintain a liquidity profile premised on recourse to markets to respond to a liquidity crisis;
P8.2 Exercise culture and behaviour with full accountability for their actions and outcome;
P8.3 Manage on the basis failure and subsequent insolvency is for the account of bank stakeholders;
P8.4 Conduct business in markets devoid of any inference or representation of government support;
P8.5 Govern to global standards pursuant to the implementation of these principles;
P8.6 Operate in compliance with the adoption of consistent local supervisory and oversight regulations.

Articulation and subscription to these principles is a necessary precursor to any assessment of R&R structures and mechanisms (the strategic options within the FSI interim report). To date, this has not been forthcoming in Australia – structures such as the Committed Liquidity Facility (CLF), whereby the RBA is the "lender of last resort", not the markets , have been introduced within a global Basel III liquidity framework to address the shortage of eligible liquid assets.

The structures are only to be assessed and adopted within a holistic framework, and there are a considerable number of models advanced offshore as exemplars for an Australian subscription, as noted earlier. While they have to be consistent with the principles and outcomes above, the FIMA view is that the most problematical is the "bail in" or loss absorbency for creditors' option. However, it remains a mechanism, and if there is market conviction that the Big 4 banks will not be subject to government support without a "bail in" mechanism, as a result of the deployment of other R&R structures eg legal separation, that may be a tenable R&R position. The IMF has assessed and commented on the legislative and legal future initiatives to accommodate an R&R framework, with Commonwealth Treasury advising that all stakeholders are onside.

In terms of the specific options, "ring fencing" within the Australian financial system merits further research and consideration, in the context of the relatively controlled trading and investment banking operations of the Big 4 banks and the " closed", domestic nature of the AUD settlement and payment systems. While it is the IMF's view that a front end payment is the appropriate model for the Financial Claims Scheme; FIMA's stance is the insured balance be reduced to prevent the unwarranted outcomes of the current $250k balance .

It may well be that public policy stakeholders are legitimately uncertain as to the extent and subscription to an R&R framework in Australia, with an upcoming G20, many of the structures untested and its high markets sensitivity. However, the principles are sound, the outcomes convincing and leadership, conviction and engagement needs to be exercised to articulate and progress an effective Australian stance.

Recommendations

R10 Statement of purpose and intent with regards to the principles and outcomes underpinning a commitment to a too big to fail R&R framework, in order to address uncertainty, transparency and engagement issues;

R11 Setting up of a working party to progress an R&R framework, with an early focus on unintended consequences, funding and markets management in the transition period and an early implementation timetable (Canadian experience as an exemplar);

R12 Comprehensive cost benefit exercise to confirm taxpayer assurance, systemic resilience, risk mitigation and international compliance dividends significantly outperform the associated costs of implementation and customer pricing.

Capital Allocation and Outcomes

FIMA notes the Inquiry observation as to the potential impact of RWA models and capital on competitive neutrality.

We assume this will be pursued, particularly in the case of secured residential mortgages, within a remit that regulatory risk settings are forward-looking, subject to regular review and compatible with individual markets risk profiles and characteristics, while subject to an overriding appraisal of systemic capital and risk governance.

We support an initiative to upgrade risk models and practices, particularly in terms of data and expertise, across the banking system, with the support of stakeholders, as a component of an overall review and assessment process of the calibration and application of risk models.

Key Principles

P9 Risk governance, compliance and oversight competencies are to be promoted across the banking system to improve its resilience and performance.

Recommendations

R13 Assessments and conclusions as to the application and calibration of capital for retail secured lending to be pursued within an open agenda to elevate risk competencies outside the Big 4 banks.

Efficiency of the Superannuation sector

FIMA has advocated selectively in only those areas where its experience and expertise reside.

An initial premise, shared with the Inquiry, is that the Government is the "underwriter" of last resort to the sector, but is seriously deficient in exercising its due diligence processes, holding stakeholders accountable, and protecting its promise. In markets parlance, it "writes a lot of free options".

Numerous surveys have confirmed that the majority of members of the public find the requisite risk assessment, investment selection and performance management skills and expertise outside their "comfort zone". The inherent portability, personal selection and self managed options of the system are in stark contrast to the reality of the publics' credentials.

This complexity, plus the proliferation of stakeholders from advisors to trustees, makes a compelling case for a simpler investment structure that meets the majority of the public needs, with My Super as a starting point. A public policy position that entitlement to access to a state pension on retirement was to be premised on a simple balanced fund offering , approved by the government , would address many of the unwanted outcomes and price the government “underwriting“ position more appropriately. There would be issues eg concentration risk, financing higher risk ventures and infrastructure and markets liquidity, but the opportunity would be presented to progress responses to the severe moral hazard in the current system.

The Inquiry’s findings on relative costs in Australia are noted. The Canadian experience suggests that in Australia there is a prevalence of a stock picking culture and finessing of investment profiles that incurs costs, as exemplified by the 2-3 pages of disclosure by funds as to managers who have 0.25% of the total portfolio and hedge the underlying currency risk. This is in marked contrast to Canadian funds, such as the Ontario Teacher’s Pension Fund, which employs cost efficient, in-house portfolio investment models, admittedly endowed with the liquidity of the North American markets and defined benefit pension schemes, to achieve investment targets. The migration of Australian funds to a similar model would deliver similar efficiencies.

The FIMA view is that the balance sheet of the funds is not efficiently allocated, to the detriment of performance, investor returns and the government liability for state pensions. Funds have an opposite liquidity profile to banks, i.e. long term liabilities and short term assets, but they hold proportionately more liquid assets than banks. This is the outcome of various factors, including a prudential supervisory stance that is looking to elevate risk governance and oversight standards in the sector, the inherent portability of the schemes and the structurally low holdings of government debt. Funds in Australia are destined to be Systemically Important Institutions (***SII***), if not there already, with a public policy stance , the relevance of a Recovery and Resolution framework and accreditation and recourse to central bank money market and liquidity facilities to be progressed.

The superannuation sector is a prime candidate for a “it’s all too difficult” categorisation across its diverse stakeholders and manifestations. Increasing numbers of the public vote with their wallet and invest in real estate, comforted in the knowledge they pay an upfront transaction cost, but are then protected from the 1-3% + annual fees that compound over 35 years to an unacceptable reduction of their pension “nest egg”. This exacerbates the investment in real estate v’s enterprising, productive investments. Fiscal and political agendas contribute, but a simpler, crisper, leaner superannuation sector is attainable to deliver some of the targeted efficiencies.

Key Principles

P10 State pensions are an entitlement, not a right, with eligibility premised on the public exercising due diligence, prudence and responsibility in conducting their financial affairs throughout their lifetime;

P11 Risk adjusted investment and performance returns, within the banking industry since Basel I in 1987, are to be progressed, calibrated and disclosed to enable transparent and risk adjusted assessment of Superfunds contributions to members.

Recommendations

R14 Review of the current regulatory regime and support facilities to assess and conclude on the sector’s SII credentials, its remit in core funding markets, contingency planning and role in a systemic crisis and financing constraints on its balance sheets (as the Super sector balance sheet will continue to accelerate).

Banking as a community and social service

FIMA's expertise and engagements confirm an irresistible momentum, frequently fuelled as a result of unintended consequences from legislation, for an increasing proportion of the population to be disadvantaged or, more seriously disenfranchised, from the banking system.

The introduction of Comprehensive Credit Reporting, tightening up of consumer credit legislation , regulatory focus on higher risk, non PAYG lending and the expanding capacity to risk price individual transactions is driving lower demographic clients outside to non bank lenders. This is complemented by the difficulties encountered in competing by the regional banks and credit unions, and reflective of the real economy, where distress indicators are high and rising.

FIMA's view is this merits greater reference within the Inquiry, within an overall public policy stance as to the extent that free markets will prevail.

D. CONCLUSION

The interim report would have been more substantive and relevant if it had been more ambitious, forward looking and exhibited greater focus on overarching principles v's strategic options.

However, we appreciate that the report is a sounding board, with a potential agenda for a final report that is more transformational and prescient to present to the Commonwealth Treasurer in advance of the upcoming G20 meeting.

We trust our comments are constructive to progress and issue the final report and would be pleased to provide additional feedback on request.

Financial Institutions & Management Advisory

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