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26 August 2014

Financial System Inquiry
GPO Box 89
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Dear Sir or Madam,

Standard & Poor's Submission to Australia's Financial System Inquiry (Second Round Submission)

Standard & Poor's Ratings Services' submission to Australia's Financial System Inquiry ("the Inquiry") discusses issues related to credit ratings, and provides input on a range of issues canvassed by the Inquiry in its July 2014 Interim Report ("the Interim Report"). Our observations and views reflect our experience as participants in the Australian financial markets, our global perspective on financial sectors and regulatory regimes, and previous research that we have undertaken. We aim to help contribute to an informed public discussion as the Inquiry works toward making final recommendations on how Australia can foster an efficient, competitive, and flexible financial system that can most effectively position the Australian economy to meet Australia's evolving needs and support Australia's economic growth.

SUMMARY OF OBSERVATIONS AND CONCLUSIONS

Credit ratings

- Credit ratings can help facilitate efficient capital markets by reducing information asymmetries, thereby fostering stronger and more sustainable economic growth. Credit ratings that are freely available to all investors increase transparency and reduce information asymmetries.
- Standard & Poor's credit ratings are independent, forward-looking opinions of relative creditworthiness (of which there may be several such opinions). They are not a proxy for an investor's independent analysis and are not issued in conjunction with any specific offering.
- Standard & Poor's credit ratings are issued and used globally, and hence there is a need for international consistency in regulatory oversight. We welcome regulatory reforms that are internationally consistent, strengthen transparency and oversight, and improve market confidence in credit rating agencies.

Broader financial system issues

- A deeper and more liquid **corporate bond market** may provide diversification benefits to both issuers and investors; however, the market may be better served if the development and deepening of the wholesale corporate bond market precedes the development of the retail corporate bond market.
- There are a number of factors—such as Australian banks' high reliance on wholesale funding—that may mean the optimal policy for Australia's **addressing of 'too-big-to-fail'** financial institutions could be different to some other jurisdictions' policies.
- We see potential risks in allowing **unaccredited** authorised deposit-taking institutions (ADIs) to use **internal ratings-based (IRB) risk weights** to calculate their regulatory capital requirements for their residential housing portfolios. Further, any resultant reduction in capital might have credit rating implications for such ADIs.
- In our view, any measures to encourage higher **lending to the small-to-medium enterprise (SME) sector** should take into account the greater risk associated with such lending.
- **Residential loans insured under lenders' mortgage insurance (LMI)** do provide an additional element of credit support and a 'second set of eyes' in the underwriting process; however, this does not necessarily mean the current IRB 20% loss-given-default floor for housing is inappropriate.
- There appears to be no clear case for ongoing government support for the **residential mortgage-backed securities (RMBS) market**, and encouraging even greater lending to existing housing might reduce economic growth and increase financial risks.
- There might be a range of consumer and broader system-wide benefits from measures to **encourage retirees to downsize their homes** rather than encouraging them to use **reverse mortgages** to release home equity.
- There appears to be a range of policy options that would enable Australian superannuation funds to become more active in **funding infrastructure.**
- Encouraging a developed domestic **annuities market** might reduce pension-system pressure on government finances—and create increased demand for long-term infrastructure assets—although this might have capital implications for insurers.
- Supporting the development of the nascent **impact investment sector** might potentially have wider benefits, including a greater focus on the measurement and achieving of social outcomes more generally, which might facilitate the more efficient reallocation of resources, over time.

The scope, use and benefits of credit ratings

A Standard & Poor's credit rating is an independently derived, forward-looking opinion of relative creditworthiness. Credit ratings can play a useful role in capital markets—and the economy more generally—through reducing information asymmetries between borrowers and investors. By reducing market distortions in this way, credit ratings can assist with the efficient allocation of capital, which in turn helps in promoting growth in economic activity and employment.

As the IMF has noted[1], credit rating agencies allow borrowers—sovereigns, corporations, and financial institutions—to access global and domestic markets and attract investment funds, thereby providing liquidity to markets that would otherwise be illiquid.

The Inquiry, in its Interim Report, made a number of references to credit ratings. On some of the issues it raised, Standard & Poor's has very different views to the Inquiry on the role of credit ratings in the investment-decision process, which we outline here. In this submission we also discuss what we consider is the most appropriate regulatory approach to credit ratings and prospectuses given the nature of credit ratings, and hence how investors should (and should not) be using them.

What are credit ratings, and how do investors use them?

A Standard & Poor's credit rating is an independent, forward-looking opinion of relative creditworthiness. The credit rating is one of many inputs that investors can consider as part of their decision-making process, and it can be one of many factors influencing market behaviors. Importantly, credit ratings are not investment recommendations, they do not address every aspect of investment risks such as, for example, liquidity and volatility, and they are not a substitute for investors' own independent analyses.

This is in stark contrast to the Inquiry's view, as expressed in its Interim Report, that "Investors use credit ratings as a proxy for, or to provide comfort in the absence of, their own independent credit assessment (pp.2-90)." We strongly urge the Inquiry not to endorse this view, as credit ratings are not intended for use in this way.

[1] IMF *Global Financial Stability Report*, October 2010

Promoting greater transparency for retail investors

We believe information asymmetries in the Australian market could be further reduced if credit ratings were available to retail investors. As we noted in our previous submission to the Inquiry, a key barrier to this (from Standard & Poor's perspective)[2] is the requirement of a credit rating agency to submit to an External Disputes Resolution Scheme (EDRS) in order for its ratings to be made available to retail investors. Our concern here is that any requirement to submit the substance of credit rating opinions for review to an EDRS would call into question the independence of a credit rating agency's credit ratings. The analytical independence of rating analysts and their opinions must be preserved; the potential for 'second-guessing' of credit rating opinions under an EDRS could adversely impact the exercise of independent judgment and be detrimental to the markets.

We again strongly encourage the Australian Government to use this opportunity to amend the *Corporations Act 2001* to exempt credit rating agencies from the requirement to be a member of an EDRS if they hold a retail license. Such an exemption would further enhance Australia's integration with the global financial regulatory framework and be consistent with objectives of the Inquiry—namely to ensure a more efficient and flexible financial system.

Do credit ratings belong in prospectuses?

The Interim Report states that "A factor affecting public offerings is that some ratings agencies will not consent to ratings being used within a prospectus, due to liability concerns and a requirement to participate in mandatory dispute resolution mechanisms (pp.2-90)."

We discussed above our concerns about an EDRS. But beyond that issue, if credit ratings were available to retail investors, we believe the ratings should not be required to be included in public offering documents.

A credit rating is an independently derived, forward-looking opinion of relative creditworthiness of either an issuer or an issue; it is not provided as a part of an issuers' offering process. The inclusion of a credit rating in an offering document has the potential to confuse unsophisticated investors by implying an expertise and a connection with the offering that does not reflect the scope and role of credit ratings as an independently derived, forward-looking opinion of relative creditworthiness. Standard & Poor's has consistently stated that we do not consent to being named an expert or any similar designation under applicable securities laws.

[2] Standard & Poor's Financial System Inquiry Submission dated 28 March 2014

Requiring, or incentivizing, issuers (by reducing disclosure requirements) to include credit ratings in offering documents also increases the risk of investors over-relying on credit ratings and reduces the incentive for investors to undertake necessary independent analysis.

We note the Financial Stability Board (FSB)[3] has announced initiatives looking at ways to reduce over-reliance on credit ratings in the financial system. A key to reducing over-reliance is to end any regulatory requirements or incentives that encourage mechanistic use of credit ratings. The better solution is to create regulation that will allow ratings to serve as one alternative—but not the sole option—to assess credit risk. Australia's response to the FSB review[4] noted "…the hardwiring of credit rating agency (CRA) ratings within elements of prudential regulation was wrongly interpreted by some investors as providing ratings with tacit official approval. This interpretation may have reduced incentives for investors to develop their own capacity for credit risk assessment and due diligence."

Developing Australia's corporate bond market

The Interim Report observes that Australia has an established, albeit small, domestic bond market, and that a deeper and more liquid corporate bond market would provide diversification benefits to both issuers and investors. The Interim Report seeks views on ways to stimulate the corporate bond market, including possibly streamlining issuance of corporate bonds directly to retail investors, and whether developing alternative credit rating schemes would improve the appetite for corporate bonds.

Larger wholesale and institutional investors are generally well-versed on the risk/return characteristics of bonds, but the same cannot always be said of smaller wholesale/institutional and retail investors. Developing a deeper institutional/wholesale corporate bond market—from which the retail bond market might then further develop—could help mitigate a rise in financial system risk stemming from the transfer of created risk to less-sophisticated investors.

In our view, a diversity of opinions about credit risk is beneficial in the market. Credit ratings are forward-looking opinions based on assumptions: **they are not statements of fact**. Differences in opinion can provide investors with important information about key inflection points. Over time, a diversity of opinions might spur investors to further develop expertise in arriving at their own informed view, and reinforce the notion that credit ratings are forward-looking opinions, and not factual statements.

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[3] FSB member jurisdictions' action plans to reduce reliance on CRA ratings
(URL: http://www.financialstabilityboard.org/publications/c_140429.htm)

[4] Reducing Mechanistic Reliance On Credit Rating Agency Ratings - Australia's Action Plan - March 2014
(page 2, paragraph 2; URL: http://www.financialstabilityboard.org/publications/c_140429b.pdf)

However, the idea of different indicators for different investor segments (e.g. a wholesale indicator for wholesale investors; a retail indicator for retail) would not, in our opinion, serve the market well. Such an approach reduces transparency and increases the potential for information asymmetry between segments, potentially creating a barrier to information and capital allocation flow. It might benefit one segment at the expense of the other, and could reduce the ability of one segment to compensate should dislocations or disruptions occur in the other. Market depth, liquidity, stability, and efficiency are ultimately enhanced by reducing barriers between alternate funding sources—not the erection of additional barriers—and having consistent benchmarks across sectors that are generally understood and accepted.

While equity is a ‘higher long-term risk’ than corporate bonds in terms of being subordinated to debt in the capital structure, the standardised nature of equity and its liquidity reduces information risk and generally provides for the quick exit of holdings, which can significantly reduce investors’ exposure vis-à-vis corporate bonds. Accordingly, we think retail investors would be well served by standardised bond terms—which would also likely help facilitate a more liquid corporate bond market.

The *Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014* may go part of the way in terms of providing some standardisation of terms for investors (as well as lowering issuance costs for corporate issuers). However, the diversity of terms and conditions related to each bond type, as well as limited liquidity, reduces the ability of small wholesale/institutional and retail investors to easily switch or exit such investments before bonds mature. It also provides more opportunity for less-sophisticated investors to inadequately price for risk. Even with credit ratings and other analytical inputs, we would question whether retail investors would be able to price for the risk differential in payment and other terms. Further standardisation around a ‘vanilla’ corporate bond market, increased investor education, and increased liquidity in the corporate bond market would, in our view, support a well-functioning and sustainable corporate bond market.

The Interim Report seeks further information on “whether alternative rating schemes could develop in Australia and would this help improve the appetite for bonds, particularly those of growing medium-sized enterprises? Could alternative standards of creditworthiness develop in Australia?”

Again, on the question of whether the market is supported by having different rating systems serving different investor segments (i.e. wholesale vs retail investors), our opinion is ‘no’, for the reasons cited above.

We agree that on the question of credit rating systems for SMEs, traditional corporate credit ratings might not fully meet the needs of those entities. However, it is also important to consider the needs of investors. SMEs might pose specific risks—including path to default, volatility, and heightened vulnerability to economic shocks—which means the credit profile of many of these entities may transition more quickly than would generally be expected for larger corporate entities. The SME sector is often substantially debt-funded, so investors might not benefit from equity buffers like they do when investing in corporate bonds. These features, rather than a lack of competition and availability of finance, could drive the tendency toward secured lending and higher lending margins in the SME sector. Any alternate rating system in this sector should reflect the particular risks of SMEs. It should not be used interchangeably with corporate credit ratings, or create confusion for investors between ratings on SMEs and credit ratings assigned on corporate bonds.

'Too-big-to-fail' financial institutions

A major focus of global regulators at present, as the Interim Report pointed out, is the issue of financial institutions that are viewed as too big to fail. Many regulators are seeking to reduce market perceptions that systemically important financial institutions will be bailed out by taxpayers in the event of financial distress. We make some observations here about our ratings on Australian banks, the Australian banking system itself, and global developments.

We believe that a shift in Australia toward a system whereby senior creditors could be bailed in in the event of a bank's financial distress could have implications for our ratings on six Australian financial institutions. Currently, we give the four major Australian banks—Australia and New Zealand Banking Group Ltd., Commonwealth Bank of Australia, National Australia Bank Ltd. and Westpac Banking Corp.—as well as Macquarie Bank Ltd. (MBL) and Cuscal Ltd. (Cuscal), ratings uplift above their stand-alone credit profiles. This reflects our opinion of the likelihood of extraordinary government support in a crisis, due to our view concerning the high systemic importance of the major banks and moderate systemic importance of MBL and Cuscal[5]. We have outlined this opinion in recent commentaries and bank rating reports[6].

Beyond the issue of credit ratings, we believe there are a range of factors that would be useful to account for in considering any changes to Australia's policies regarding the 'too-big-to-fail financial institutions. We note that Australia's banking sector and economy are reliant on the ongoing support of domestic and foreign wholesale investors, and we believe that a shift in these investors' perceptions of Australia's risk profile, stemming from a view that the government is potentially less supportive towards the banking system, could lead to (or exacerbate in a downside scenario) a range of disorderly adjustments in the Australian economy. In particular, we believe Australia could find it challenging to effect an economic recovery in circumstances whereby a key source of funding upon which the recovery would likely depend—senior unsecured creditors—had been 'bailed in' during the downturn.

[5] For the avoidance of confusion, Standard & Poor's bank ratings criteria has its own definitions for systemic importance which are applied to our bank ratings globally. Hence, APRA's list of D-SIFI's may differ from the banks that we define as being of systemic importance for purposes of assigning our credit ratings.

[6] For example, see commentaries "Australia's Developing Crisis-Management Framework For Banks Could Moderate The Government Support Factored Into Ratings", published Nov. 12, 2013; "Resolution Plans For Global Banks May Eliminate Government Support For Some, But Progress Is Varied", Dec. 4, 2013; and "No Impact On Australian Financial Institution Ratings Following The Australian Financial System Inquiry's Interim Report", published Jul. 23, 2014

From a global perspective, Australia is a small economy and geographically remote. Consequently, we believe that there is some merit in the argument that Australia needs to present a strong relative-value proposition externally to remain an attractive destination for investment, and to partially mitigate the risks associated with having a high reliance on funding from offshore markets. In particular, the relative creditworthiness and stability of the sovereign and banking system, the regulatory environment, and business conduct and governance are key elements that historically have positioned Australia well in the eyes of global investors.

In Europe and some other regions in which bail-in resolution powers are being more strongly advocated, we note some difference from Australia. First, those jurisdictions have lower banking sector reliance on senior unsecured wholesale funding compared with Australia. Second, governments in those jurisdictions have injected significant equity to support banks following the recent global and European financial crises, which we believe has likely influenced the current discussion on the appropriate resolution regime. Third, covered bonds play a major role in bank funding in some countries, whereas in Australia they play a supplemental role; we note that in those jurisdictions covered bonds are specifically excluded from proposed bail-in provisions and would not be susceptible to losses should senior creditors be forced to absorb losses.

Capital requirements for authorised deposit-taking institutions (ADIs)

The Interim Report raised the possibility of allowing unaccredited ADIs to use IRB risk weights to attain accreditation, or at least to adopt IRB modelling for mortgages. This is based on the observation that the application of capital requirements is not competitively neutral. Banks that use IRB risk weights have lower risk weights for mortgage lending than do smaller ADIs that use standardised risk weights, giving the IRB banks a cost advantage.

An inherent assumption in this argument seems to be that the risk profile of residential mortgage loans of the major banks and smaller ADIs is homogeneous—but we believe that might not be the case. Competitive position, risk management systems, and asset concentration could all contribute to differentiation in the credit profile of ADIs' housing loan portfolios. These differences tend to be understated in benign economic conditions and stable-to-rising property prices, in our view. The assumption also fails to take into account IRB calculations being dynamic and therefore subject to change over time.

Further, we believe IRB risk weights are susceptible to being pro-cyclical, and may therefore understate risk in periods of benign economic conditions. We therefore question the benefits in expanding IRB application to smaller ADIs; however, we acknowledge that allowing smaller ADIs to become IRB-compliant could promote improvements in their credit-risk-management systems as they undertake the accreditation process, and possibly provide additional incentives for reducing the riskiness of their lending.

Standard & Poor's relies on its own risk-adjusted capital (RAC) framework in assessing capital adequacy. We believe the RAC framework overcomes shortcomings we see arising from the current regulatory approach. Looking at banking systems globally, we observe inconsistency among capital ratios, determined by different banks' internal risk models and regulators' discretion. Consequently, we believe regulatory capital ratios across banks are not comparable, and in our view they do not provide good indicators for investors.

Recently, we have seen a number of examples (including in Denmark, Norway, and the U.K.) of regulators challenging banks' internal models and are requiring standard risk weights in calculating risk-weighted assets. So far this year, the Basel Committee has published consistency assessments of regulatory risk-weighted assets for market and credit risk, and found material differences in outcomes for identical risks. We expect that these differences are likely to lead more regulators to challenge banks' models to a greater extent than previously, particularly in the case of countries or particular institutions where current risk weightings appear most aggressive.

If smaller ADIs move to using IRB risk weights for their residential housing portfolios, all other things being equal their minimum regulatory capital requirements may reduce. Any resultant reduction in capital held by or in the capital buffer within the respective credit ratings on these ADIs could have a ratings impact or make these ADIs more susceptible to future downgrades. We note that our current view of capital for many Australian regional banks and mutuals is "strong" or "very strong", which results in ratings uplift in how we derive our credit ratings for these ADIs.

At a more macro level, we also think such approaches may potentially divert more credit to the housing sector—which, in our opinion, appears (by many measures) to be well serviced—(with the majority of lending directed toward established housing rather than the construction of new dwellings), at the expense of more productive sectors of the economy (a theme we touch on a number of times in this submission). IRB risk weights will generally lower capital requirements for housing-related lending, and may therefore skew new lending toward the housing sector.

Further, we note that the Interim Report also seeks views on whether capital requirements on the financial institutions considered to be systemically important domestically (D-SIFIs) should further increase. There are several reasons to increase, cited in the Interim Report as including: (i.) reducing the cost advantage of IRB banks over standardised banks due to differences in the risk weights for housing-related lending; (ii.) effectively charging a 'premium' to institutions that may benefit from market perceptions of implicit government support due to the perception that these institutions are too big to fail; and (iii.) lowering the probability of failure in the first place. If the Inquiry concludes that increasing capital requirements on D-SIFIs is desirable, will it also consider different options for calibration of D-SIFI capital to promote more desirable system-wide and long-term outcomes in line with the Inquiry's overarching objectives?

Is funding to the SME sector 'too' restricted?

The Interim Report makes the observation that there are structural impediments for SMEs' access to finance, including information asymmetries, regulation, and taxation, as evidenced by the higher cost, more restrictive terms, and lower availability of credit for SMEs relative to large business loans and mortgages. In our view, the primary reason for this relates to risks associated with lending to SMEs. As the Interim Report notes, SMEs typically have more volatile revenue streams and are more likely to default. Given the higher risk associated with SMEs, we believe that caution should be taken in seeking to promote higher lending to this sector. However, we would also agree that a stronger SME sector might promote stronger economic and employment growth.

The Interim Report also finds that there are "greater information asymmetries between lenders and SMEs compared to larger borrowers", and seeks views on the costs, benefits, and trade-offs of facilitating development of an SME finance database to reduce information asymmetries between lenders and borrowers. We note that by virtue of their size and scale, the major banks effectively have their own internal information databases upon which to draw. If the Inquiry concludes that increased access, transferability, and competition in the SME lending sector is desirable, the development of market-wide information databases might be worthy of further consideration and investment. We note that given the increased risk profile of SMEs generally, any such endeavor would be greatly enhanced by the inclusion of recovery data. Market-wide information databases may create efficiencies for certain lenders; this could: have some impact on cost; facilitate increased transferability; and enable the development of a market for securitized SME loans.

We also note the Interim Report's comments regarding limited access to equity and venture capital finance in Australia for SMEs. We agree with the Interim Report's statement that venture capital is more suited to start-up firms in nascent industries than to the provision of debt finance.

Should LMI-insured residential loans have preferential capital treatment?

We note the Inquiry seeks views on whether the risk weights for insured loans could be decreased under the IRB approach. We note our earlier comments highlighting our view that IRB may be susceptible to being pro-cyclical and therefore may understate risks in periods of benign economic conditions. Further, we note from the Interim Report that "In its submission, APRA states that the 20 per cent loss given default floor for housing lending has been set until IRB banks develop appropriate methodologies and estimates for a downturn period."

We observe a number of benefits of Lenders' Mortgage Insurance ("LMI"). These include assisting borrowers in entering the housing market, providing credit enhancement to the securitization market, and contributing capital and earnings protection to the banking sector at a time of stress. In our opinion, LMI-insured loans provide an additional element of credit support and a 'second set of eyes' in the underwriting process.

While there is high correlation of risk between LMIs and the wider financial sector—in terms of house prices, unemployment, and loan-repayment affordability—we think that LMIs provide access to wider and diversified credit support.

This credit support includes ownership and contractual support from parent companies that may be based offshore, or are heavily weighted to life insurance or property-casualty lines which are less correlated with economic cycles. Credit support may also arise from access to offshore-domiciled reinsurance protection from a variety of counterparts. LMI also provide access to greater geographic diversification to help offset the impact of state-based economic downturns, where individual lenders may have some concentration; as well as inherent lender diversification which dissipates the impact of delinquency bias from an individual lender.

In addition to providing credit support, we see the benefit of LMIs as providing a 'second set of eyes' to supplement the underwriting process, as well as monitoring through the loan servicing process (we do not observe lenders to be absolving themselves from underwriting responsibility through the purchase of the product). We see evidence of this benefit through both arms-length LMIs as well as captive LMIs that have independent regulation, operations, and governance.

However, LMI policies do have certain risks and limitations, which in our opinion, somewhat temper these positive aspects. In essence, these relate to the fact that LMI is not a guarantee but an insurance policy with certain exclusions and performance obligations upon the insured; furthermore, in certain markets that have experienced higher levels of housing stress than Australia, we have observed that claims adjustment percentages have a tendency to increase in periods of economic stress.

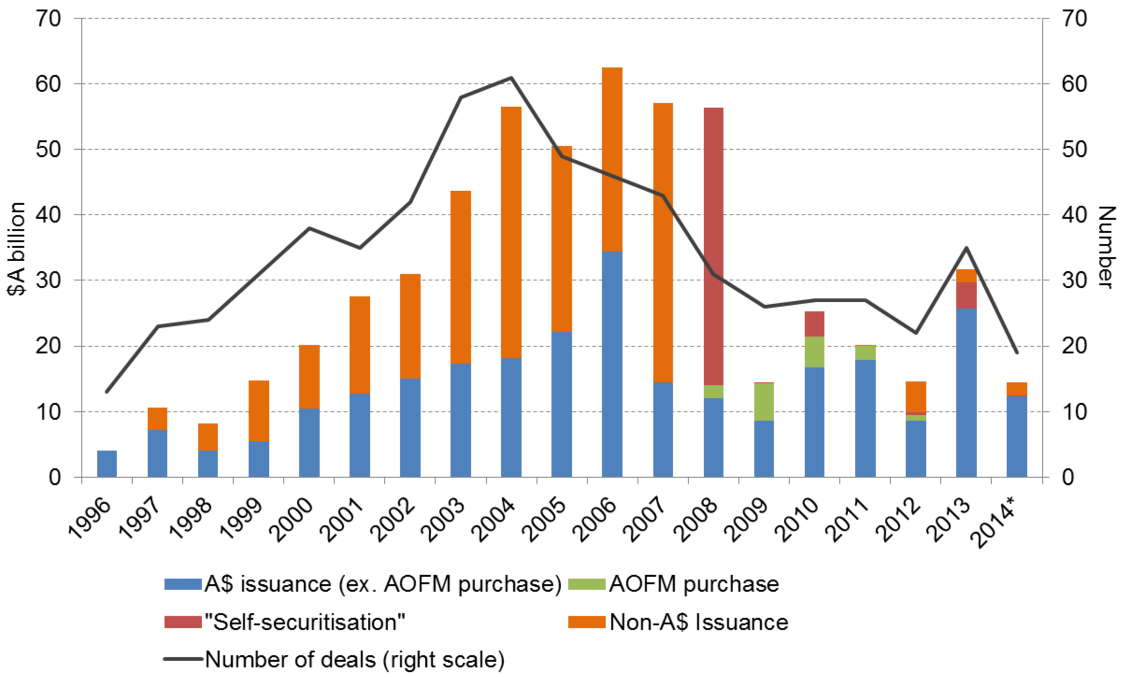
Is government support in the RMBS market really sensible?

The Interim Report states "There is little evidence that the current state of the RMBS market and the associated deterioration in the competitive position of smaller ADIs and non-bank lenders relate to an ongoing market failure". We note the Interim Report seeks views on the costs, benefits, and trade-offs of providing direct Government support to the RMBS market.

We agree with the Interim Report's statement that there is limited evidence of a clear and ongoing market or regulatory failure in the domestic RMBS market, thus negating the case for government to provide ongoing direct support to this market.

It is true that Australian RMBS new issuance levels have not returned to their 2006-2007 peaks, although issuance volumes are growing and issuance margins have tightened— in our opinion, signs that the market is functioning and recovering. Further, we note that at the peak of the market, a significant proportion of new issuance was being purchased by offshore investors at very low margins, and many of which no longer exist. We don't expect issuance levels to reach 2007 heights again in the short-to-medium term in the absence of such investors; nor do we think those levels of issuance and issuance margins are the appropriate benchmark by which to determine whether the current market is functioning or not.

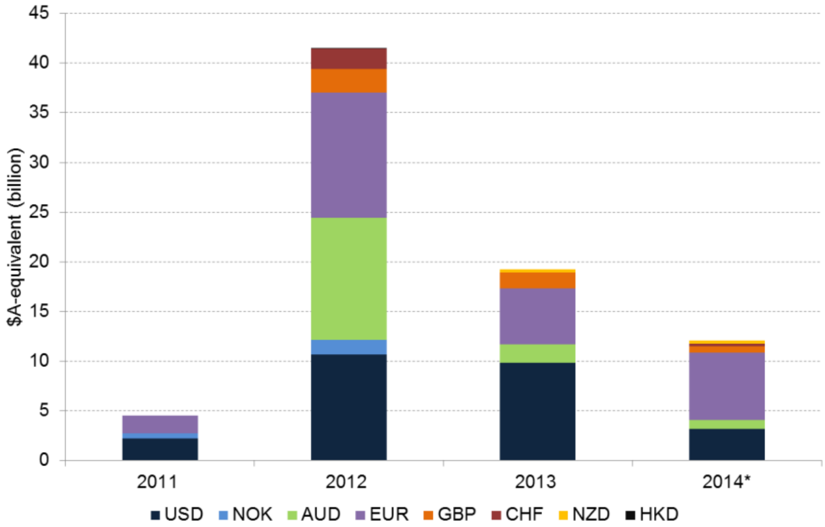
Chart 1: RMBS new issues market placement



* Year to June
Sources: AOFM; Standard & Poor's

We also note the emergence of the covered bond sector has provided an additional capital markets funding source, predominantly for the major banks in funding their residential housing-loan portfolios in Australia. Excluding AOFM purchases of Australian RMBS during the global financial crisis (GFC), internal securitisations undertaken for eligibility to RBA repurchase facilities and including Australian covered bond issuance, domestic market issuance of RMBS or housing-loan backed covered bonds seems reasonably healthy relative to historical issuance levels, in our view.

Chart 2: Australian covered bond issuance by currency of issue



* Year to June

Sources: Australian major banks' websites; Standard & Poor's

Should RMBS be considered a highly liquid asset for financial institutions?

The Interim Report seeks views on the costs, benefits, and trade-offs of allowing RMBS to be treated as a high-quality liquid asset for the purpose of banks' liquidity coverage ratios.

As noted in the Interim Report, the GFC dislocated the RMBS market. Indeed, in some periods the market was essentially closed. We cannot reconcile the fact that the RMBS market has demonstrated that it is not liquid in periods of stress with arguments that such assets should be treated as liquid for regulatory purposes.

Is there really benefit in stimulating more housing-related debt?

Looking beyond the role of RMBS in financial institutions' funding base, we question whether it is sensible for the government to seek to further stimulate access to credit for housing. Higher credit for housing could exacerbate financial risks, divert credit away from more productive uses, and may decrease housing affordability for potential first home buyers.

Most credit for housing is non-productive: it is channeled to existing, rather than new, housing, and puts upward pressure on asset prices. Greater access to housing credit may put further strong upward pressure on house prices. This would increase the risk of a disorderly correction in property prices down the track, which may hurt economic growth and risk financial instability. Beyond the risk of a sharp property price correction, higher house prices would further lower housing affordability.

A negative economic shock would be exacerbated by an even more highly leveraged household sector. We already view the household sector as highly leveraged, driven by previous run-ups in house prices. Promoting higher household leverage could therefore raise households' financial vulnerability even further.

By channeling more credit into housing, this could potentially crowd out some credit that might otherwise be available to more productive sectors of the economy. We discuss other implications of over-investment in housing later, when we address ***reverse mortgages***.

We have also discussed related issues in a recent article titled "*Australian Bank Ratings Holding Up As Cheap Money And Rising Residential Property Prices Entice Australian Households*", published on July 28, 2014.

Should insurance aggregators have greater access to general insurance data?

The Interim Report seeks views on whether insurance aggregators should have greater access to information in the general insurance space. An insurance aggregator is an online website function allowing a client to gain several quotes electronically from insurers with which the aggregator has some arrangement. It observes that general insurers in Australia have been reluctant to share their product information with aggregators, which in turn has slowed aggregators' growth in these markets, and possibly reduced price competition. Suggested options involve ensuring aggregators are able to use automated processes to seek quotes from general insurance websites, or provide for insurers to disclose policy data for defined representative consumer categories, which aggregators could then use to compare different product offerings.

We witness the success of the aggregators' business model, especially in the U.K. motor insurance market, where they are the largest distribution segment and have contributed to substantial premium-rate reduction in recent years. While we acknowledge the benefits of price comparison and ultimately lower premium rates for consumers, it can be at odds with maintenance of insurance providers' financial strength, and ultimately the level of security afforded to consumers. Under our methodology for rating insurers, the growth and traction of aggregators could contribute to more negative rating factors, including weaker operational barriers to entry in the industry, lower levels of controlled distribution, weaker operating performance, and for some, weaker brand strength and market share.

In developing any specific proposals to assist insurance aggregators, decision-makers might take into account possible unintended reductions in the insurance sector's viability, which would ultimately affect consumers. The Australian general insurance market, especially for motor and home insurance lines, has operated largely on a direct basis or through bank distribution, with consumers directly accessing quotes from the handful of major providers and niche providers. This is different to some other major international markets, where the number of insurance offerings is substantial and broker or intermediary distribution is more prevalent. Opening up product information fully to aggregators can adversely impact customer retention—and increase insurer expenses—by allowing higher risk policies to be written at a price that might not have been acceptable under conventional underwriting and distribution practices.

Positioning to respond to long-term challenges and opportunities

The Interim Report notes that “There is an opportunity for financial and policy innovation to deliver better outcomes for retirees and assist Australia to meet the challenge of an ageing population (pp.4-3).”

In our opinion, Australia’s financial system should allow it to meet the challenges of the next decade and beyond. Similar to the long-term challenges facing most other countries, Australia will need to adapt to the economic impacts of an ageing population and climate change. There is also widespread acknowledgement that Australia needs to boost productivity to maintain growth in living standards, including by investing in infrastructure. Meanwhile, governments at all levels are fiscally constrained.

Australia’s financial system therefore needs to create the correct incentives for shifting behavior over time to reduce waste and increase the efficient use of resources.

We see a number of areas in which incentives may not be aligned with the most efficient uses of available resources, potentially leading to slower economic growth, higher financial risks, lower equity, and greater pressure on government finances than could otherwise be the case. Many of these opportunities relate to aspects of the financial system regarding the retirement phase of households’ lifecycles.

What role should reverse mortgages have in financing retirement?

The Interim Report notes the reverse mortgage market and the consolidation in the number of providers since the GFC. The Interim Report also highlights certain risks associated with reverse mortgages (pp.4-32).

Reverse mortgages might have an important role to play in providing options to older Australians, particularly those for whom staying in the family home is both desirable and beneficial, and those whose financial risk tolerance and expectations are aligned with the characteristics of the product. However, aligning incentives (or removing disincentives) for older Australians to unlock equity in the family home by downsizing may also be desirable—both in terms of the financial return/cost to retirees and the government, and optimising resource utilisation of the existing stock of housing. The appropriate level of competition in our view will strike a balance between the well accepted benefits of competition to consumers without inadvertently promoting the potential overuse of the product when other solutions may be more appropriate.

Reverse mortgages have certain risk characteristics that might not be fully appreciated (or may be discounted) by consumers. The amount finally owed on the reverse mortgage might be significant relative to both the initial amount advanced and the value of the property at termination. The tenor of the reverse mortgage (and we note there may be risks with both shorter and longer than expected tenors), interest rates at the time the reverse mortgage is entered into, over the life of the reverse mortgage, and at termination, and property market conditions may all significantly impact outcomes for consumers. The amount ultimately owed might not match borrowers' expectations, nor meet their financial needs after the reverse mortgage becomes due and payable. In particular, to the extent that current expectations about future interest rates (remaining low), property prices (always rising), and longevity do not eventuate, consumers could experience significant dissatisfaction with and loss from the product. Downsizing, on the other hand, would have the benefit of releasing equity without the potential risks of compounding negative interest; indeed, surplus funds could initially be invested to supplement income needs.

Encouraging downsizing by older households might also facilitate more efficient use of the current housing stock. Retirees who downsize would potentially be moving into a more manageable and lower-maintenance property (which might have associated lifestyle benefits as well), and releasing larger properties for use by families for whose stage of life would better suit a larger house.

While noting the importance of housing investment at the current stage of Australia's economic cycle, it is worth considering whether higher-than-needed physical investment in housing could potentially be: (i.) crowding out investment in more productive resources, thereby reducing Australia's growth potential; and (ii.) sustaining higher current account deficits than otherwise, with the associated risks to financial stability.

While outside the scope of the Inquiry, we note that existing welfare-policy arrangements discourage older households from downsizing from the family home later in life. In particular, the (uncapped) exemption of the principal home from pension eligibility means-testing does little to encourage retirees to downsize.

Superannuation and the infrastructure funding challenge

The Interim Report notes that "Investments in infrastructure are viewed by some as being illiquid. Infrastructure investment could be facilitated by developing liquid, tradable claims on infrastructure projects. This could provide greater scope for retail and institutional investors, including superannuation funds, to invest in infrastructure (pp.2-72)."

In our view, the large and growing pool of households' retirement savings sitting within the superannuation system provides an opportunity for funding investment that will drive stronger economic growth. In particular, the pool of superannuation funds could be used to help fund infrastructure, given the budget constraints faced by Australian governments.

Yet there are a number of barriers to the superannuation industry's participation in infrastructure.

A major barrier may be the mismatch between superannuation funds' liquidity needs and the illiquid nature of infrastructure as an investment class. Canadian pension funds, for example, don't face the same requirements and therefore can invest much more heavily in infrastructure. (We note that some of the largest Canadian pension funds are also linked to the Canadian government and are invested in the Canadian public sector, which may also influence asset allocation.)

As defined benefit schemes (as opposed to defined *contribution* schemes, as in Australia), Canadian funds can focus more strongly on maximizing long-term returns and stability of returns over time, and less on investing in liquid asset classes. In particular, Australian super funds need to maintain liquidity because consumers can more easily switch between super funds at will in the pursuit of higher returns; in Canada, defined benefit schemes mean consumers have little reason to switch between pension funds. (For the avoidance of doubt, we use this example solely to illustrate the impact of the liquidity mismatch, and not to suggest defined benefit schemes are superior or preferable to defined contribution schemes.)

In addition to the illiquid nature of infrastructure investment, the relative return profile of infrastructure compared with the listed equity market may be another consideration in the Australian context. Consumers' ability to switch funds may influence asset allocation preferences toward a focus on short-term (potentially) higher returns to reduce their incentives for switching in the first place. Further, fund manager remuneration systems in Australia tend to reward returns generated, rather than reward achieving long-term stable returns.

While offshore pension funds might be an important source for financing Australia's infrastructure, they are not necessarily optimal. In our opinion, encouraging stronger Australian super fund participation could provide a more stable source of funding. Meanwhile, domestic fund managers might be able to better assess and price the risk of domestic assets, potentially providing cheaper funding.

There is general acceptance of a positive relationship between infrastructure investment and economic and productivity growth. If growth is a key policy objective, and illiquidity is determined to be a key inhibitor to accessing private sector funds to fund viable infrastructure projects, then supporting the development of liquid, tradable claims on infrastructure projects through private sector innovation or co-investment models with the government are worthy of further consideration.

Policymakers may also consider whether the current superannuation system provides the right trade-offs between consumer choice and the classes of viable super investments (noting that currently, consumers seldom exercise their freedom of choice). The Australian Government's 2010 Super System Review, for example, canvassed some options in this regard. Encouraging a more developed annuities market in Australia might also help address the mismatch between income products and the investment characteristics of infrastructure (see our discussion of ***annuity-style retirement products***.)

There is also an alternative perspective or argument in the market that there is a lack of 'investable projects' (i.e. those that meet minimum credit quality and return parameters) in which capital-markets investors can participate—and no shortage of capital that is ready, willing, and able to be allocated to the 'right' projects. The Interim Report notes that key issues raised in submissions to the Inquiry "relate to infrastructure project selection and design, and the implications for the pipeline of greenfield projects. This is consistent with the Productivity Commission's recent draft *Public Infrastructure* report. The Commission found: *There is no shortage of private sector capital that could potentially be deployed to finance public infrastructure in Australia. Private capital markets will finance most projects at the 'right price'* (pp.2-72)."

Further, Industry Super Australia notes in its submission cited in the Interim Report that *"Industry SuperFunds have already made clear that they would make infrastructure investment of up to $15 billion over the next five years if appropriate projects were made available. Reform of the bid process could well see them accelerate or even increase that projected level of investment".*

Challenges surrounding the funding of future infrastructure to drive economic and productivity growth are not isolated to Australia. We note that infrastructure investment and funding features prominently in this year's B20 recommendations to the upcoming G20 meetings in November 2014 as key enablers for driving growth and jobs. In particular, we note two of the recommendations to: (i.) establish, publish, and deliver credible national infrastructure pipelines that have been rigorously assessed and prioritized by independent infrastructure authorities, and which take full advantage of private sector finance and expertise; and (ii.) establish an Infrastructure Hub with a global mandate to disseminate leading practice to facilitate the development and delivery of pipelines of bankable, investment-ready infrastructure projects.

Annuity-style retirement products

As Australians grow older and live longer, longevity risk will become more pressing unless there is reform. But there are difficult decisions to make, as governments and retirees look to strike a balance between flexibility of control and certainty of income.

Australia faces challenges associated with an aging population, including the prospect of the elderly outliving their retirement savings and the Australian Government being faced with a steadily rising burden in its age-pension scheme. Among the possible solutions the Interim Report has proposed is to make particular retirement income products, such as long-term annuities, compulsory—either at a certain level of retirement assets or at some stage in retirement. Whether or not annuities become compulsory, we see potential benefits to both retiree and government finances of a more developed annuities market in

Australia. But we believe that some tax, distribution, and regulatory reform is required to support meaningful growth in Australia's longer-term annuities market. (See our recent article, *The Longevity Dilemma: Why Australian Life Insurers Could Soon Be Writing More Annuities).*

We anticipate the retirement income market eventually shifting away from a focus on investment products and allocated pensions to a more balanced mix, with a greater proportion of annuities. But without reform, demand for annuities is likely to remain constrained, thanks to a legacy of inequitable tax treatment, the availability of the age pension government safety net, limited flexibility in existing product features, and unfavorable consumer perceptions. And on the supply side, a lack of profit incentive for life insurers, a shortage of high-quality domestic assets of longer-term duration, and restrictive regulations may in varying degrees be contributing to the limited supply of long-term annuity products in Australia. While product diversity ultimately helps insurers protect against regulatory and market risk, we note that we expect capital requirements to increase for insurers that enter the long-term annuity market, associated with increased longevity risk as life expectancy improves, possible asset/liability mismatching between reserves and assets held, and higher asset risk charges on property and infrastructure assets. (To match future growth in longer-term annuities, Australian life insurers will likely look to invest more in long-duration, illiquid assets such as property and infrastructure.)

When analysing the possible outcomes of any Australian retirement reforms, it's useful to consider the U.K.'s experience. While annuities have been a longstanding feature of the U.K. retirement income system, reforms in that market are moving to greater consumer freedom outside of annuity products. Australia could therefore observe that the U.K. reforms aim to maintain consumers' financial flexibility, improve consumer outcomes at retirement, and, in terms of prevailing market conditions, reduce the concern associated with retirees having to lock into annuity payment streams at a time of historically low interest rates.

Impact investment and social impact bonds

The Interim Report notes the role the emerging impact investment sector may play in "encourage new markets, entrepreneurship and innovation to solve entrenched social issues (pp.2-73)." Further, "more impact investment activity could trigger a marked change in the way governments deal with social or environmental problems by supporting entrepreneurs to find new solutions to entrenched problems. It could also shift governments' approaches to dealing with these problems from paying for service delivery to paying for outcomes at the best price. However, mobilising the impact investment market may require government support, including removing barriers (pp.2-74)."

In our view, long term mega-trends of aging populations and climate change will, over time, adversely impact government revenues, while the social needs, society's expectations, and the costs of delivering social outcomes will all likely rise. To best meet these needs in the future within a more fiscally and resource-constrained environment, Australia might need to develop an even greater focus on measuring social impact and achieving social outcomes to determine how best to allocate those resources, and create pathways for increasing private sector participation in financing and delivering social outcomes.

Providing support and encouraging the development of the nascent social impact investment sector today—including innovation and investment in measuring social impact more effectively across a broad range of current social programs—might potentially have wider benefits, in our view. Specifically, it could enable the more efficient reallocation of capital over time toward programs that provide the highest social returns (not only in relation to those financed by social impact bonds) and facilitate greater private sector participation in funding certain programs.

Concluding remarks

We thank the Inquiry for affording us the opportunity to contribute to the market discussion on how the financial system can most effectively help the Australian economy be productive, grow, and meet the financial needs of Australians in the future. I and my colleagues have appreciated the opportunity to prepare this submission, and we hope you find our insights useful. We would be very agreeable to discussing our submission further with you at a convenient time, should you wish. Please do not hesitate to contact me if you have any queries regarding this submission.

Yours sincerely,

Fabienne Michaux
Australia/New Zealand Country Head
Standard & Poor's Ratings Services

Research articles

We include here a number of our previously published research articles that may be of interest to the Inquiry, including those referred to above.

- The Longevity Dilemma: Why Australian Life Insurers Could Soon Be Writing More Annuities, Aug 25, 2014
- Outlook On Six Big Canadian Banks Revised To Negative Following Review Of Bail-In Policy Proposal, Aug. 8, 2014
- Banking Industry Country Risk Assessment Update: August 2014, Aug. 5, 2014
- How Increasing Income Inequality Is Dampening U.S. Economic Growth, And Possible Ways To Change The Tide, Aug. 5, 2014
- Australian Bank Ratings Holding Up As Cheap Money And Rising Residential Property Prices Entice Australian Households, July 28, 2014
- No Impact On Australian Financial Institution Ratings Following The Australian Financial System Inquiry's Interim Report, July 23, 2014.
- Climate Change: Preparing For The Long-Term, May 22, 2014
- Climate Change Is A Global Mega-Trend For Sovereign Risk, May 15, 2014
- Climate Change: What Are The Risks To Corporations?, July 11, 2014
- The Greening Of The Corporate Bond Market, May 20, 2014
- All In On Bailing-In? Global Resolution Regimes Take A Mixed View, May 5, 2014
- Resolution Plans For Global Banks May Eliminate Government Support For Some, But Progress Is Varied, Dec. 4, 2013
- CreditStats: Australian And New Zealand Financial Institutions Credit Statistics, Nov. 28, 2013
- Australia's Developing Crisis-Management Framework For Banks Could Moderate The Government Support Factored Into Ratings, Nov. 12, 2013
- Banking Industry Country Risk Assessment: Australia, Oct. 1, 2013
- The Top 100 Rated Banks: The Consensus About Capital Is Unraveling, Sept. 30, 2013
- Global Aging 2013: Rising To The Challenge, March 20, 2013
- Australia Has More Than Luck To Endure Downside Risks, Feb. 26, 2013
- Global Aging 2010: Australia, Oct. 11, 2010
- Global Aging 2010: An Irreversible Truth, Oct. 7, 2010