Bendigoand
AdelaideBank

Financial System Inquiry

Second Round Submission
in response to the
Inquiry's Interim Report

High standards – lower burdens
Level playing field
Consumer protection
Innovation in retirement incomes

August 2014

Bendigo and Adelaide Bank Submission

Bendigo and Adelaide Bank

26 August 2014

Mr David Murray AO
Financial System Inquiry
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Dear Mr Murray,

Firstly, please accept our congratulations on the Interim Report and the Panel's Inquiry process to date. It has been fair, thoughtful and balanced and has undoubtedly worked in the best interests of our sector and the Nation as a whole.

Bendigo and Adelaide Bank (BEN) appreciates this opportunity to make a second round submission and to respond to a number of issues and options posed in the Interim Report.

We remain committed to the view that the Financial System Inquiry is a timely opportunity for Australia to review the current state of its financial system and determine the most appropriate framework for the future.

We also support a more cohesive and principle-driven approach to the financial system to ensure that all participants are focusing on common outcomes that support national prosperity.

In an approach consistent with the first round of submissions, BEN is participating on three separate levels:

- firstly, through this submission which provides BEN's own feedback on four specific sets of issues and options;
- secondly, together with other regional banks, we are submitting on specific matters that largely relate to the need for a level playing field in domestic banking; and,
- thirdly, at an industry level through the Australian Banker's Association, where industry matters are addressed.

Our joint venture company, Homesafe Solutions Pty Ltd (ACN 106 784 918) is also separately making a second round submission.

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This submission provides specific feedback in relation to:

- Regulatory capital requirements for banks;
- Payments system regulation;
- Efficiency in the superannuation sector;
- Retirement income products, specifically access to equity in the home.

More generally, BEN stands by its view that a bank's role within the economy should include financial, economic and social responsibilities, and regulation and government policy should support that role.

We would encourage the Panel to consider these important themes as it develops its final recommendations for Government.

BEN again thanks the Inquiry Panel for the opportunity to provide our feedback and would welcome the opportunity to discuss this submission with yourself and Panel members at our upcoming meeting.

Yours sincerely,

Robert Johanson
Chairman,
Bendigo and Adelaide Bank

Mike Hirst
Managing Director,
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Executive Summary

This submission provides specific feedback in relation to four key themes.

1. Regulatory Capital Requirements for Banks

Further extend the tiered risk weights under the standardized approach to capital adequacy to lower the risk weights for the highest quality residential mortgages.

Accelerate the accreditation process to achieve accreditation under the IRB approach to capital adequacy.

Capacity to undertake a portfolio-based accreditation process without undermining the integrity of the framework.

2. Payments system regulation

Payment systems of similar economic substance should be regulated on a consistent basis.
The weighted average cap on interchange fees be retained.

A maximum interchange fee be introduced at a level to be determined by industry consultation.

3. Efficiency in the Superannuation sector

The Bank supports the view of the Inquiry that, in general, competition has led to feature-rich, but more costly, superannuation products.

Banks are well equipped to provide customers with the advice they require to make informed investment decisions relating to MySuper products.

4. Retirement income products, specifically access to equity in the home

The policy and regulatory framework should recognise and facilitate products that allow retiree's to release equity in their home to supplement their retirement income.

Furthermore, pooled residential property is regarded as a new asset class and is likely to require some form of Government assistance to attain acceptance with institutional investors.

Background

The Bendigo and Adelaide Bank Group is a community focused retail bank that commenced operations in 1858. In 2007 Bendigo Bank merged with Adelaide Bank to form Bendigo and Adelaide Bank Limited, now the fifth largest domestic retail bank in Australia with a credit rating of at least "A-" from all three international rating agencies.

The strategy of the Bendigo and Adelaide Bank Group is built on a vision of being Australia's leading customer-connected bank. This is based on focusing on the success of all stakeholders of the Bank including shareholders, customers, our people, partners and communities.

The principal activities of the Group are the provision of banking and other financial services including lending, deposit taking, transaction banking, leasing finance, margin lending, superannuation and funds management, insurance, agribusiness, treasury and foreign exchange services (including trade finance), financial advisory and trustee services.

The retail banking businesses operating under the Bendigo Bank brand provide a full suite of traditional retail banking, wealth and risk management services to customers through a national network of more than 500 company owned and Community Bank® branches. The Group's customer facing brands also include Rural Bank (a wholly owned subsidiary with a separate banking licence), BendigoWealth (incorporating Sandhurst Trustees and Leveraged Equities), and DelphiBank. The Group also recently purchased the Rural Finance Corporation of Victoria, building further agri-capability and support for regional and rural customers.

Bendigo developed the innovative Community Bank® model over 15 years ago to partner with discrete communities to provide retail banking services and enable their sustainability.

Based on this significant experience in working with communities, the Group's initial submission to the Financial System Inquiry advocated enabling communities to develop the capability and resources that underpin their sustainability, growth and resilience.

It also advocated the creation and support of innovative solutions to address underserviced market demand, and drive improved productivity and inclusion.

While these priorities are unchanged for the Group, the immediate priority as a smaller ADI is to encourage competitive neutrality in the principles and recommendations the Panel ultimately recommends to the Australian Government.

The burdens and barriers for smaller ADIs competing with major banks remain great; there will only be competitive neutrality when these are addressed and the implicit guarantees major banks receive from Government are counterbalanced.

Finally, the need to address market concentration and the accompanying distortions is not just a matter for smaller ADIs and their customers – it is also pertinent for the existing customers of the major banks and the wider Australian economy.

Regulatory Capital Requirements

The Interim Report said:

The banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral. Banks that use internal ratings-based (IRB) risk weights have lower risk weights for mortgage lending than smaller authorised deposit-taking institutions (ADI's) that use standardised risk weights, giving the IRB banks a cost advantage.

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

- *No change to current arrangements;*
- *Assist ADI's that are not accredited to use IRB models in attaining IRB accreditation;*
- *Increase minimum IRB risk weights;*
- *Introduce a tiered system of standardised risk weights;*
- *Lower standardised risk weights for mortgages;*
- *Allow smaller ADI's to adopt IRB modelling for mortgages only;*
- *Provide direct Government support to the RMBS market, or allow RMBS to be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio.*

Bendigo and Adelaide Bank response:

The regional banks submission to the Inquiry of March 2014 strongly advocated for the Inquiry to pursue a regulatory framework based on competitive neutrality.

The argument that there is a competitive advantage for IRB banks is compelling when you compare the weighted average risk weights under the IRB and standardised approaches. The Pillar III reports lodged with APRA disclose that IRB banks generate an average risk weight of 18% across their entire residential mortgage portfolio and single digit risk weights for the highest quality loans. By comparison, regional banks have an average risk weight of 39% and a minimum risk weight of 35% on the highest quality residential mortgages. The discrepancy is the most pronounced for lower loan to valuation (LVR) loans which is a primary mitigant of loss given default. This is a stark difference in outcomes that is not reflective of the risk being assumed by standardised banks.

BEN strongly support the observations that the alternate approaches to capital adequacy under the APRA prudential framework is not competitively neutral and delivers a significant cost advantage for banks approved to apply the IRB approach. This is due to the far lower levels of capital required to support their residential mortgage portfolio.

BEN accepts that banks approved under the IRB approach have demonstrated that their risk management frameworks are robust and meet APRA's standards to identify and manage key risks across its business on an ongoing basis. Banks on the standardised approach have not achieved that accreditation. There is, therefore, justification for risk-weights under the advanced IRB approach to be lower than under the standardised approach.

The primary issue is whether the risk-weights prescribed under the standardised approach are unduly conservative and not a true reflection of the risk. The risk-weights for residential mortgages for regional banks under the standard approach are more than twice that for banks assessed under the IRB approach on a weighted average basis. The result is that regional banks are required to hold more than twice as much capital as IRB banks to support essentially the same risk.

Residential mortgage lending has been a core business of BEN for over 150 years. Other standardised banks in Australia also have a long history in that market. Standardised banks have experience through many economic cycles and stressed periods.

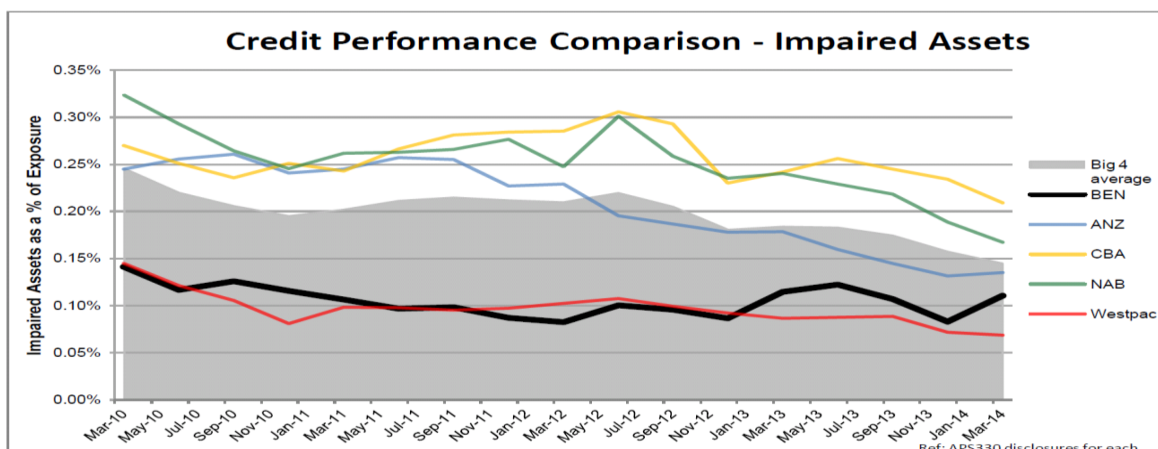
The residential mortgage market in Australia is relatively homogenous with the risks clearly understood. The policies and procedures of standardised and IRB banks are relatively uniform. All banks apply stressed interest rates, consider all other debt commitments, undertake credit checks, and apply conservative allowances for living expenses when assessing a borrower's capacity to pay. The valuation policies and LVR limits based on geographic location, security type, and product features are broadly consistent for all banks.

This does not take away from the more robust approach required to achieve accreditation under the IRB approach but the historical performance of smaller banks indicates that the gap is far narrower than the disparity in the risk weights and the standardised and IRB approaches infer. A unique feature of the Australian residential mortgage market is the practice of banks mortgage insuring residential mortgage loans. Lenders mortgage insurance covers any loss on a defaulted loan where the amount recovered following the sale of a security property is less than the amount outstanding under a loan. The benefit of mortgage insurance is not only the first loss credit support provided to banks but more importantly, the overlay of minimum credit and risk management policies and practices across the banking system. All banks use mortgage insurers, in particular for higher risk loans. Lenders mortgage insurers impose a floor on the credit and lending practices of all banks, large and small, in the Australian market.

The market for residential mortgages is very competitive. Base rates offered by all banks are broadly comparable as are net interest margins. The main disadvantage for standardised banks is the impact on the return on equity (ROE) by being required to hold, more than twice as much capital to support residential mortgages than IRB banks on a weighted average basis. It is not possible to deliver the same return to shareholders due to the capital arbitrage to IRB banks under the prudential capital framework. The capital advantage also provides greater scope for IRB banks to offer heavy pricing discounts to borrowers to drive growth.

APRA noted In its initial submission to the Inquiry that, all else being equal, an ADI using the standardised approach would have to charge 23 basis points more than an IRB bank to achieve the same ROE for a residential mortgage. There are many variables that feed into the calculation of ROE including the weighted average cost of funds, the funding mix, operational expenses, overheads, and the cost of origination channels that vary across banks that may suggest that APRA's estimate may be understated for individual banks.

The delinquency rates on the residential mortgages of regional banks are marginally higher than for IRB banks which, in the case of BEN, reflect a willingness to work with borrowers to resolve their circumstances rather than to automatically resort to the conventional legal recovery process. The anecdotal evidence of the mortgage insurers is that the gross and net loss experience of standardised and IRB banks are broadly consistent and low by global comparisons. This is evidenced by the extremely low loss rates disclosed by rating agencies on RMBS transactions collateralised by residential mortgages securitised by standardised and IRB banks. The Pillar III reports lodged with APRA detail the level of impairments on residential mortgage portfolios. The following graph reveals that the level of impairments for BEN has tracked below the IRB banks over the past 4 years.



APRA made a few observations in its initial submission to the Inquiry. It indicated that IRB banks are subject to additional requirements for interest rate risk in the banking book, whereas standardised ADI's are not and was of the view that direct comparisons between IRB and standardised risk weights overstate any competitive advantage for IRB banks. The residential mortgage market in Australia is predominantly a variable rate market that aligns with a largely floating rate funding base. While interest and basis risk are fundamental components of all banks balance sheet and risk management frameworks, it presents a far lower risk than markets such as the US where the residential mortgages are non-recourse fixed rate loans. In addition and as mentioned above, all banks assess a borrower's capacity to service a loan by applying a stressed interest rate. The level of stress applied is broadly consistent across all banks.

APRA noted that the risk weights of the IRB banks vary over time in line with their loss performance. All banks vary their credit policies and procedures in line with the prevailing and forecast economic climate.

APRA concluded that smaller ADI's may need higher regulatory capital buffers than their larger competitors as they have less sophisticated risk management systems, albeit with less complex risks, and have relatively concentrated loan books. While that conclusion has some foundation, the mitigants referred to above suggest that any buffer should be at the margin and nothing like the disparity that currently exists for residential mortgages under the standardised and IRB approaches as currently framed.

It is very difficult to quantify the capital advantage of IRB banks over standardised banks other than on an asset level such as residential mortgage loans. Standard & Poor's employs a risk adjusted capital methodology (RAC) as a key element of its rating process for banks. The RAC ratio provides a globally consistent and comparable assessment of a bank's capital adequacy ratio. It also reflects the difference between Standard & Poor's risk assessment and regulatory ratios. The RAC readily permits a comparison of the absolute levels of capital held banks, on a risk adjusted basis, free of the distortions of applying alternative methodologies. The following table compares the RAC ratios for two standardised banks and four IRB banks.

BANK	RAC RATIO (%)
Standardised Banks	
Bank of Queensland	15.5
Bendigo and Adelaide Bank	11.5
IRB Banks	
Westpac	9.1
ANZ	8.4
CBA	8.3
NAB	7.8

The table reveals that standardised banks hold significantly more capital under Standard & Poor's risk adjusted methodology than IRB banks. In other words, when measured on a like for like basis using an IRB-like approach the two regional banks hold materially more capital than IRB banks. A RAC ratio between 7% and 10%, the range within which the IRB banks sit, is considered adequate. The standardised banks are above that range. This is, in part, a derivative of the alternative capital approaches under APRA's prudential capital adequacy framework. Clearly, this also refutes any view that additional capital is required over and above that already held by regional banks were they to move to IRB risk weights for capital adequacy.

The conclusion drawn from the above is that there is little to distinguish between the performance of residential mortgages of standardised and IRB banks even though the IRB approach under the APRA capital adequacy framework is based on a presumption of a more robust risk management framework.

The regional banks, in their submission in response to the interim report of the Inquiry, have proposed a very conservative adjustment to the risk-weights of the highest quality residential mortgages under the standardised approach. While the specific details of the adjustment are contained in the regional bank submission, in broad terms they recommend extending the tiered risk weightings under the standardised approach to reduce the risk weighting on the highest quality standard residential mortgages with an LVR of less than 80% from 35% to 20%. This narrows the gap in weighted average risk weights but retains a material buffer between risk weights for the highest quality loans under the standardised and IRB approaches. BEN strongly supports the recommendation of the regional banks to extend the risk weighting tiers under the standardised approach.

Changes to capital requirements are critical in rebalancing the "playing field". It is unsustainable for there to be no change to the current arrangements.

The Inquiry seeks further information on how the Government or APRA could assist smaller ADI's to attain accreditation.

Banks accredited under the advanced or IRB approach to capital adequacy have a significant competitive advantage over banks assessed under the standardised approach. BEN acknowledges that the IRB approach provides an incentive for banks to achieve accreditation and that it is in the interests of standardised banks, APRA, and the banking system generally for standardised banks to attain accreditation. Consumers and business will also benefit when banks can compete on a level playing field.

BEN is committed to seeking accreditation under the IRB approach and nearing the point of lodging an application with APRA. The path to accreditation is protracted, opaque, inefficient, expensive, and creates significant business risk. The process to achieve accreditation is now more onerous with the hurdles set at higher levels than when the alternate approaches to capital adequacy were first introduced in Australia. There is scope for the path to accreditation to be accelerated and made more efficient. The process could be streamlined through active engagement and collaboration with APRA throughout the course of the process to permit the scope of the project and APRA's expectations to be more fully understood and to assess the progress of banks at regular intervals. The current process is a binary "Pass-Fail" system covering the entire banking group and creates a significant barrier for smaller ADIs, particularly given the very material fixed costs that are involved.

Increased flexibility in the application of the IRB standard would reduce the competitive disadvantage for banks during the process leading up to full accreditation and provide benefits to consumers and business. Options include decoupling the accreditation process by permitting accreditation for specific portfolios such as residential mortgages and introducing measures to achieve partial recognition of the accredited risk management framework during the lengthy transitional period. The adoption of these options will not affect the stability of the system as the risks outside of the portfolios receiving specific accreditation will continue be managed and measured under the more conservative standardised approach.

A further option proposed by the Inquiry was *to Increase minimum IRB risk weights.* BEN notes that regulators globally are reviewing the risk weights under the IRB approach as a result of the experience of IRB modelling through the GFC but BEN has no basis to propose an increase in IRB risk weights.

The Inquiry sought comments on the option to *Provide direct Government support to the RMBS market, or allow RMBS to be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio.*

Securitisation is an important element of the balance sheet management strategies for all banks in Australia. Both capital market and self-funded RMBS programs provide increased flexibility to manage the capital, funding, and liquidity requirements of all banks. Covered bonds also provide highly rated banks such as the major banks with access to an additional source of cost effective funding although it is not a viable option for regional banks and other ADI's.

There was significant focus on parts of the securitisation market during the GFC, in particular the subprime RMBS and other exotic structured products such as synthetic CDO's. A general view is that the GFC was, in part, attributable to the misapplication of these products.

It is important to distinguish between the over-engineering of these products in offshore markets from Australian RMBS. Prime RMBS in Australia performed impeccably all through the GFC with no defaults on any tranche of securities issued under any program. This is a reflection of both the vanilla and transparent structures in Australia and, more importantly, the quality and performance of the underlying residential mortgages collateralising the transactions. Investors globally recognise that the residential mortgage market in Australia is sound with the risks well understood and appropriately managed which is reflected in the strong performance of Australian RMBS.

Securitisation markets globally experienced significant disruption during the GFC. The Australian Government recognised the importance of the RMBS market for regional banks and other ADI's and supported the market through a bond acquisition program. The market for Australian RMBS has recovered with strong demand for new transactions. As a result, the Government was in a position to withdraw the support and sell down its holding at a profit.

The exceptional performance of Australian RMBS and the underlying residential mortgages throughout the GFC and the return of investor demand for the securities as the market came out of the GFC provides strong support for including Australian prime-RMBS as high-quality liquid assets for the purpose of the liquidity coverage ratio. The impact of this change would be an increase in the liquidity and pricing of RMBS thereby helping realign the competitive issues through providing smaller ADI's with funding at better prices and increased capital management opportunities.

The Inquiry noted that there are structural impediments for small- and medium-sized enterprises (SME) to access finance. The far more favourable capital treatment of residential mortgages compared to loans to small business and higher ROE's under the IRB approach to capital, together with the streamlined and efficient procedures to consider and process applications for housing loans, create significant incentive for IRB banks to direct funding to housing should capital and/or funding be constrained.

Other impediments such as the complex documentation also contribute to the lack of growth in funding for SME. The centralised credit score driven process employed by larger banks makes it very difficult to work with borrowers to understand their business and the true risk. The process becomes too difficult for SME, particularly in regional and rural regions.

BEN works hard to assist SMEs across its business and understands the importance of creating jobs and sustainable economies in local communities The recent comments by Professor Deborah Ralston of Monash University and the Australian Centre for Financial Centres illustrates the concerning state of SME lending.

She referred to IMF analysis that found Australia "had the highest proportion of real estate on any set of bank balance sheets" and that "Banks have responded to the increasing risk of small business in a rational way. They have reduced their commitment to it." She also stated that the margin for SME lending is now roughly twice of large business lending.[1]

[1] http://finsia.com/news/news-article/2014/08/24/fsi-must-address-business-lending-decline

Payments system

The Interim Report said:

Observation

Regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral.

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

- *No change to current arrangements;*
- *Lower interchange fee caps or ban interchange fees;*
- *Expand interchange fee caps to include payments of similar economic substance;*
- *Remove interchange fee caps;*
- *Cap merchant service fees or cap differences in interchange service fees between small and large merchants;*
- *Require acquirers to enable merchants to choose which scheme to route transactions through;*
- *Allow payment schemes to reintroduce 'no surcharge' rules or broaden the ban on 'no surcharge' rules to all payment systems;*
- *Enforce reasonable cost recovery in customer surcharging;*
- *Provide merchants and customers with real-time pricing information regarding interchange fees and merchant service fees.*

Bendigo and Adelaide Bank response:

Bendigo and Adelaide Bank strongly supports the Interim Report observations relating to payment systems, in particular:

- *Differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral. (page 2-3)*
- *...That interchange fee caps have improved the functioning of four-party payment schemes. They have reduced merchant service fees. Although difficult to measure, the caps have also most likely reduced cross-subsidisation from customers who use low-cost payment mechanisms, such as cash, to those who use high-cost payment schemes. (page xix)*
- *... payment systems of similar economic substance should be regulated consistently. Arguably four-party interchange fees, companion card service fees and incentive payments under all schemes are equivalent in economic substance. (page xix)*

Payment schemes are regulated under the Payment Systems (Regulation) Act. The RBA designated the credit and debit card payment schemes operated by MasterCard, Visa and eftpos under the Act. Access regimes are also applied to ensure that smaller and non-ADI participants can enter and compete in these markets. The regulation capped the weighted average interchange fees and removed restrictions on merchants such as customer surcharging. Bendigo and Adelaide Bank supports the principles and intent of the RBA reforms, specifically that:

- Price signals are not efficient in four-party payment schemes, which can result in competition and paradoxically lead to higher prices, and that;
- Interchange fees act like price floors for merchant service fees.

The RBA is of the view that interchange fee caps have reduced merchant service fees following the introduction of payment system regulation. BEN supports the view of the Inquiry that interchange fee caps have improved the functioning of the of four-party payment schemes.

Three-party payment schemes, such as Amex and Diners, and companion cards are not currently covered by the regulatory framework as no interchange fees are involved. Companion cards are a blend of the three- and four-party payment schemes under which service fees are paid to the issuer. Both the three-party payment schemes have the same economic substance as regulated four-party payment schemes.

The unregulated payment schemes have increased pricing flexibility as fees are not capped and create a competitive advantage over four-party payment schemes. BEN strongly supports three-party payment schemes and companion cards being subject to the same regulatory framework as four-party payment schemes to establish a level playing field for all cards. Consistent with the analysis provided in the Interim Report, such a move would mitigate the tactical use of incentives to drive consumer take up, and would encourage more efficient and innovative performance.

While weighted average interchange fee caps have delivered benefits to merchants and consumers, the periodic interchange fee reset process allows some scope to manipulate fees at the expense of acquirers, merchants and customers. Issuers seek to address the competitive advantage held by non-designated schemes to encourage customers to move to higher interchange earning premium cards. An option to address the arbitrage of interchange fees on premium cards is to impose a maximum interchange fee that may be applied to cards. The amount of the maximum fee could be determined by industry consultation. This would also reduce the amount of surcharging if all payment schemes were subject to consistent regulation.

Superannuation - Efficiency

The Interim Report said:

There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system.

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

- *No change to current arrangements and review the effectiveness of the MySuper regime in due course.*
- *Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.*
- *.....*

Bendigo and Adelaide Bank response:

The Bank supports the view of the Inquiry that, in general, competition has led to feature-rich, but more costly, superannuation products, in part reflecting that many consumers are not fee sensitive and it is too early to assess the effect of recent reforms to default arrangements (MySuper) on fees.

The primary objective of superannuation is to allow individuals to save for retirement and reduce or remove the reliance on Government funded pensions. Compulsory employer superannuation contributions on behalf of employees were introduced in 1992 with the amount of the minimum contribution progressively increased over the subsequent period. Concessional tax benefits are available to individuals and superannuation funds to encourage additional contributions and maximise returns of the funds.

The superannuation system now represents $1.8 trillion in assets, with the Super System Review (The "Cooper Review") forecasting the aggregate amounts in superannuation funds to grow to 130% of GDP by 2035.

The public superannuation funds offer a range of investment options to customers based on their risk appetite and/or time to retirement. The investment options can broadly be described as cash, stable, balanced, and growth. The funds may be actively managed or indexed.

While there are many investment options available to consumers, it is ironic that the historical longer-term performance of the various funds has not revealed any material difference in returns. The significant growth in superannuation funds, increased competition, and resultant economies of scale were expected to drive down the fees and expenses of funds and increase returns to members. This has not eventuated leading to a significant amount of criticism of superannuation fund managers.

The Grattan Institute's explanation is a lack of fee-based competition, and specifically a lack of transparency around fee structures and net returns makes it difficult for consumers to compare the performance of funds.[2]

The superannuation offerings of funds are complex and lack transparency. Financial planners and advisors are engaged by consumers to assist in selecting funds and investment options that fit their specific circumstances and risk appetite. This adds an additional layer of expense for consumers and further erodes the amount available to contribute to superannuation.

Superannuation in Australia is portable and may be readily transferred to another fund if members are not satisfied with any aspect of a fund such as performance, risk profile, or fee structure. Many consumers are now disengaged or indifferent as a result of the costs and lack of transparency with existing funds.

Self-managed superannuation funds (SMSF) have emerged to be the largest sector of the superannuation system. Consumers were seeking to take more control over their investment strategies as well as to address the adverse affect high fees and expenses were having on the net returns of traditional superannuation funds.

At the other end of the spectrum, the Government introduced superannuation system reforms in 2011 following the Cooper Review. Those reforms included the introduction of MySuper.

MySuper was introduced to be a simple and cost-effective superannuation product with a simple set of product features to replace existing default products. It was also intended to address the high fees and costs of existing superannuation funds. Members do not pay for unnecessary components they don't need or use. MySuper products must offer a single diversified investment strategy that is suitable for the vast majority of members and a standard set of low cost fees to all prospective members. MySuper products are authorised and regulated by APRA.

MySuper products are readily comparable. The simpler range of product features enable members to compare funds more easily based on a few key variables – cost, investment performance, and the level of insurance cover. Trustees have a specific duty to deliver value for money, as measured by long term returns, which are enforced by APRA. MySuper products are also subject to more transparent and comparable reporting standards and disclosure requirements that ensure consistency of reporting based on long term returns.

The Government has mandated detailed design requirements for MySuper products. The recent introduction of the MySuper product dashboard was intended to provide consumers with important information about MySuper products, and for this information to be presented in a standardised manner to allow products to be easily compared and to make more informed choices.

Competition in the wealth management sector appears to be focused more on securing distribution channels and improving product features, rather than reducing fees. The superannuation system delivers significant choice and diversity of fund structure. This includes investment options for those who want them and default options for the less engaged.

Consumers often seek financial advice regarding superannuation products due to the complexity of traditional superannuation products.

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[2] Minife, Jim *Super sting: how to stop Australians paying too much for superannuation* Grattan Institute, April 2014

By contrast, MySuper is an uncomplicated superannuation product designed as a default product with a narrow investment strategy and offered in a regulated and controlled way. The increased comparability, transparency, and regulatory oversight of MySuper products does not warrant the added expense of financial advice required for more complex investment products where a customer is simply seeking a "no-fills" default superannuation product. This offers scope for increased efficiencies in the superannuation system. Consumers are in a position to make informed decisions regarding the selection of a default MySuper product.

Managers of authorised MySuper products should be permitted to offer the products through their regular distribution channels where internal compliance and risk management frameworks ensure that the product is appropriately explained and understood by customers.

Banks are well equipped to provide customers with the advice they require to make informed investment decisions relating to MySuper products. Imposing an unnecessary added layer of expense relating to financial advice reduces either the net return to consumers or the amount available to contribute to a MySuper account without any tangible benefit. Portability also provides consumers with the comfort that they can readily transfer their superannuation funds to another fund including another default MySuper fund if they are not satisfied with the performance of the fund.

Retirement - Access to equity in the home

The Interim Report said:

There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.

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

A spectrum of options to achieve the objectives of the retirement income system and position Australia to manage the challenges of having an ageing population:

- *Maintain the status quo with improved provision of financial advice and removal of impediments to product development.*
- *Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.*
- *……*

The Inquiry seeks further information on the following area:

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

Bendigo and Adelaide Bank response:

The Superannuation Guarantee framework ceases at retirement. The Inquiry noted that, at retirement, retirees make critical, once-in-a-lifetime decisions regarding when and how to draw down their savings over the remainder of their lives, and how to manage the investment, inflation and longevity risks involved. Many retirees are unprepared for these decisions. Many individuals are concerned about outliving their savings.

It is important that the policy framework for individuals post retirement facilitates a broadening of the range of financial products to allow retirees to fund their retirement. The Inquiry has observed that the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.

More generally, the interim report assessed the retirement income system and products against how well they provide for the three main attributes of income streams desired by retirees:

- Income — the expected income during retirement from a given accumulated balance.
- Risk management — including protection from longevity, investment and inflation risks.
- Flexibility — a range of characteristics, including access to one-off withdrawals during retirement, the ability to bequeath assets and control over investments.

For many people, the only material asset they have at retirement is their home. Of those, many will not have sufficient superannuation available to provide an adequate income over the rest of their life. Both create a significant impost on the Government to fund their retirement. In addition, the retirement income system does not adequately enable many individuals to effectively manage the risks in retirement, in particular longevity risk and risk of illness.

Equity release products allow retirees to access the equity of a property while retaining ownership. The products are often categorised as either reverse mortgages or home equity release. The primary benefit of these products is to allow retirees to release some equity in their home to supplement their retirement income or provide a lump sum for a specific purpose.

Individuals and couples often fund their retirement through a combination of superannuation, voluntary savings, with a possible supplement from an age pension. Home equity release products offer retirees access to additional funds and an option to manage the range of risks that emerge during retirement.

The policy and regulatory framework should recognise and facilitate products that allow the release of equity in their home to supplement their retirement income. Government promotion of the concept of home equity release as a legitimate component of retirement plans would increase the awareness and benefits of such a product.

In relation to the Inquiry's own characteristics of retirement income products, equity release and particularly home reversion products undoubtedly have strong risk management and flexibility characteristics.

However, for equity release products, the existing legislative and regulatory framework is inadequate. These products allow a consumer to sell a portion of their home in exchange for a fixed proportion of the proceeds of the home when it is sold. Home equity release products provide certainty in relation to the proportion of the value of the property that will be available when the property is sold.

The National Consumer Credit Protection Act currently regulates at the product level, by establishing a set of checks on reverse mortgages. It provides no guidance to either consumers or providers of other home equity release products, and specifically home reversion products. Furthermore, this regulation at a product level will not prevent the introduction of "rogue" products that would inevitably erode confidence in home equity release.

The inadequate regulatory framework is a fundamental impediment to the wider acceptance of home equity release. Specifically, a legislative framework should include the most fundamental issue being that the right to reside in the home must be sacrosanct.

The second impediment is the significant shortfall in the supply of funding for the two main types of home equity release products: being home reversions and reverse mortgages. A fundamental issue facing both product types of products is a lack of willingness of major financial institutions to develop funding solutions.

A home reversion offering creates a diversified pool of interests in residential property, which does not fit into an established asset class. There is uncertainty over the timing of income, as it is not possible to predict exactly when the homes of retirees will be sold and a share of the proceeds received by the pool. It would take time for a secondary market to develop. The asset pool created by a home reversion offering is therefore illiquid and unusual.

A 2011 article[3] in The Australian newspaper by eminent economist Professor Ian Harper concluded:

> "The government needs to consider how best to encourage private investors, including superannuation funds, to invest in diversified claims on the future sale proceeds of people's houses. It may simply need to prime the pump, as it has done in the market for residential mortgage backed securities, to encourage the private sector to step in.
>
> An active market in debt-free equity release offers greater choice to older Australians in retirement and advanced age, as well as creating a new asset class for Australian institutional investors. The government stands to gain from a reduced call on public funds, which is why the Productivity Commission calls on it to make the first move."

Essentially the investment can be described as a new asset class and as such does not warrant adequate consideration because there are other defined and accepted investment options. In the past other investment classes have faced similar hurdles and once accepted, have thrived. Pooled residential property is regarded as a new asset class and is likely to require some form of Government assistance to attain acceptance with institutional investors.

The third impediment is the need to comply with the property laws of the States and Territories. These regulatory impediments for home reversions are significant on account of the fact that home reversions are treated as a property transaction, and property law in Australia is State based. At the State and Territory level, issues impacting on home reversions include stamp duty and differences in the structure of real estate contracts.

These issues variations make it extremely difficult to manufacture a cost efficient home equity release product to be offered in all States and Territories. The solution would be for all regulation in relation to home equity release products to be at the Commonwealth level. For example, an Approved Home Equity Release Product should not be subject to State based property taxes and State based property regulation.

Fourthly, inadequate financial literacy about home equity release of both homeowners and advisers is an impediment. An information campaign by ASIC would significantly assist educating homeowners and advisers, including both legal and financial advisers.

Finally, the present means testing of the age pension can be a disincentive to home equity release because cash amounts released are included as an asset for the purposes of the assets tests. An alternative would be to exempt amounts accessed by home equity release for say a set period (eg five years) in order to eliminate the disincentive.

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[3] See http://www.theaustralian.com.au/opinion/unlock-home-savings-to-fund-old-age/story-e6frg6zo-1225993848749