Financial System Inquiry

Interim report overview

July 2014

Building a better working world

Overview

The Financial System Inquiry (the Inquiry), chaired by David Murray AO, received more than 280 submissions from industry, government agencies and the public. With regard to the Inquiry's terms of reference, its Interim Report (the report) released on 15th July points to 28 observations on Australia's financial system and puts forward several propositions and questions to stakeholders for further debate.

As expected, the report has not drawn conclusions at this stage, simply proposing alternative policy options for most observations. Its overarching sentiment is that Australia's financial system enabled a relatively sound exit from the financial crisis. However, sustaining confidence in the system is a central plank of the work of the FSI.

Post the Wallis Inquiry in 1997, the financial system has been subject to an extensive amount of change. This includes significant growth in the superannuation sector, a large amount of global regulatory reform, as a result of the global financial crisis (GFC), in conjunction with technological developments impacting the provision and use of financial services. Despite these changes, David Murray indicates that the financial system has remained strong and resilient, yet there is scope to enhance and improve the system in the future.

In our view, the three main themes to emerge from the report are:

Banking – The report highlights financial system stability as a key priority. In our view, consideration of maintaining system stability is likely to trump competition.

Superannuation and Retirement Income – The question is not whether change is required, but rather what policy options may be most appropriate to address the retirement income and longevity challenge.

Financial Advice – Disclosure is not the only piece of the puzzle. Rebuilding consumer confidence is likely to require an enhanced regulatory and supervisory regime – across the entire value chain of product design, manufacture and distribution.

Banking

Stability – Is a significant area of focus of the report, where safety of the system and consumer confidence is deemed critical. The Inquiry is looking for options to strengthen the financial system to ensure Australia is well positioned to navigate the next financial crisis. Financial institutions should also not be complacent and not expect Government support in the event of a crisis.

Several submissions argue that certain Government actions during the GFC, including in Australia, entrenched perceptions that some large financial institutions are too-big-to-fail (TBTF). The report acknowledges that these institutions have lower funding costs, by virtue of higher credit ratings, and that some institutions are TBTF.

The report notes that it is also difficult to value a potential advantage to larger institutions over the inherent benefits of economies of scale. However, the main objective should be to reduce the extent of moral hazard in the financial system. The Inquiry asks for views on a range of potential approaches to this issue, from increasing prudential requirements and improving regulatory powers, to the unlikely and costly option of ring-fencing.

The report also suggests considering a mechanism to assess systemic risk, whereby the prudential perimeter can be flexed to apply regulation to activities that may pose systemic risk.

Competition – Larger institutions argued in submissions that competition was not an issue. In contrast, smaller players felt the application of risk-weightings resulted in larger banks having an unfair competitive advantage. Banks that use internal ratings-based (IRB) risk weights have lower risk weightings for mortgage lending than smaller authorised deposit taking institutions (ADIs) that use standardised risk weights. Smaller institutions also contend that market concentration is growing, due to increasing levels of vertical integration.

The report considers the banking sector is competitive albeit concentrated. Market competition has also benefited from a period of low interest rates. David Murray notes that, for large institutions, net interest margins and return on equity levels have not increased significantly and consumers appear to have choices. The Inquiry asks for further views on the rationale for IRB accreditation for smaller ADIs. In this regard, a number of potential policy options are raised in the report.

Financial advice – The recent Senate Inquiry into ASIC and uncertainty in respect of the FOFA reforms will be an important focus area of the Inquiry.

David Murray believes the Inquiry's interim observations are aligned with the Senate Inquiry and asks for further views on ASIC's mandate and the appropriateness of the consumer protection framework. The report also focusses on the failure of the existing disclosure regime to adequately protect consumers and requests options for addressing consumer loss from misconduct, including more effective regulation, stronger penalties and enforcement.

Many submissions provided commentary on consumer outcomes, including poor quality of financial advice, lack of training of advisors, financial exclusion, financial literacy and the inadequacy of PDSs and disclosure. The report calls for further submissions in relation to enhancing consumer financial literacy, minimum education and competency standards, access to low cost advice and use of technology. Potential options for drawing clearer distinctions between financial advisers, types of advice and services are also sought.

Observations made above in relation to Financial Advice are also relevant to the Asset Management and Insurance sectors.

Funding – The report discusses potential options to reduce the risks associated with Australia's use of offshore bank borrowing. It also indicates that SME access to funding is inhibited, with a large housing bias in the system with respect to lending. The regulatory and tax factors that have limited the development of the domestic bond market in Australia are also discussed.

The report outlines impediments, such as information asymmetries, regulation and taxation with respect to SME finance. In the Funding chapter, the Inquiry also spends time discussing the risks associated with the banks' skewed concentration towards housing as an asset class, although taxation policy settings also distort consumers' decisions towards housing as an investment. The Inquiry asks for options to mitigate risks associated with the housing market on the financial system and the economy.

Technology – Banks highlighted cyber-security and digital identity strategies as key risks. A number of banks identified that new entrants offering like products were not necessarily subject to the same regulation.

The report suggests reviewing the current strategies in place for both cyber-security and digital identities, including consulting with industry and other jurisdictions. The report also requests views on adjusting the regulatory perimeter and adopting a graduated framework, with thresholds linked to risk and scale of activity for new technologies and new entrants.

International Integration – Several submissions called for more Government support to facilitate international competitiveness of the Australian financial system offshore, including greater efforts to coordinate regional solutions. Submissions also highlighted that Australia tended to conservatively and early adopt international regulatory reform impacting international competitiveness, including regulations that have extraterritorial impacts.

The report asks for views on ways to better consider implementing international standards and foreign regulation, including views on a coordinating body and industry's role in effecting international integration.

Taxation – Many submissions queried the current taxation regime and related distortions on funding. The report has summarised certain observations relating to taxation, but has deflected consideration of these to the Tax White Paper.

Wealth & Asset Management

Superannuation – Is a major focus of both submissions and the report. This reflects the growing size of the sector and implications for the financial system.

Competition and efficiency – Costs and fees appear to be high compared to international funds.

The report asks for further feedback on:

- Competition in the superannuation sector. Will MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns?
- Mechanisms to reduce fees in default funds, including MySuper
- The extent of active asset management and a focus on short-term returns by funds
- Additional mechanisms to manage liquidity, including the effect of portability of benefits between funds and investment switching within funds.

SMSFs – Several submissions raised concern over the growing size of SMSFs relative to the total superannuation sector and therefore whether current regulation of SMSFs (via the ATO) was satisfactory. The report considers that oversight by the ATO is appropriate, given there is no agency risk, yet seeks further views from stakeholders. The report does consider further regulation of SMSF administrators of scale, given perceived concentration.

Leverage – The report suggests direct leverage in superannuation warrants consideration, noting the general lack of leverage in the superannuation system is a major strength of the financial system. The Inquiry seeks further views to restore the general prohibition on direct leverage of superannuation funds on a prospective basis.

Regulation – In addition to the above comments, submissions also referenced asset allocations and the volatility of superannuation policy settings in terms of change. The report considers the lack of stability of superannuation policy settings is adding costs to funds, which are ultimately borne by members – noting that continual change can reduce confidence. The report also asks for feedback on whether superannuation should be prudentially regulated, given the compulsory and long-term nature of funds, or whether funds should be regulated similar to managed investment schemes.

Retirement Incomes – The question regarding compulsion to take part or all of retirement benefits in the form of an income stream, rather than a lump sum, needs to be addressed. Several submissions referenced the possibility of products other than annuities and the role for insurers in managing longevity risk, not just in terms of retirement income, but also aged care accommodation and health.

Taxation – We believe specific tax policy issues needed to address the retirement income question must be elevated by the Inquiry. This will ensure the broader White Paper Tax review develops tax policy positions and tax rules consistent with the broader policy issues of addressing increasingly important retirement income solutions and longevity issues.

Insurance

The report acknowledges the importance of the role the insurance sector plays in the economy and for individuals.

Competition – The report notes that, despite the high level of concentration in the insurance sector, few submissions raised concerns about competition and regulation did not appear to be a major barrier to market entry. Therefore, there does not appear to be any burning platform to seek major policy initiatives in relation to increasing market competition in the insurance industry.

Affordability and availability – The report comments on both affordability and availability of insurance and highlights specific areas the Inquiry considered, including low income population segments and high risk areas. At this stage, there is little appetite for government intervention in these areas.

Underinsurance – While acknowledging the importance of underinsurance from a community and broader economic perspective, the report highlights that the amount of information available on the extent of underinsurance across the various sub sectors in Australia is limited. The Inquiry has yet to gain clarity around the size and the extent of the issues, and therefore whether any form of policy response is warranted. The Inquiry requests further evidence and submissions on this area from industry.

Aggregators – The report notes submissions commented on the relative lack of use of aggregators in the general insurance industry compared to other segments of the insurance industry (such as life and travel insurance). It questions the costs, benefits and trade-offs to consumers of allowing aggregators access to more information from insurers to allow easier price and feature comparisons.

Statutory insurance schemes – The report notes that several insurance classes such as workers compensation and personal injury insurances, are covered by government or state-owned schemes. It questions whether consumer outcomes could be improved by opening up these schemes to more competition from the private sector.

Risk based pricing – The report notes that the increase in the use of data and technology could lead to more granular risk-based pricing, which in turn could make insurance cheaper for some customers and more expensive for others, effectively leading to less 'pooling' of risks across the community. Although the current impacts of this kind of trend appear relatively minor, the Inquiry is seeking views on whether more attention should be paid to this in the future.

Legacy products – The report acknowledges the impact that legacy products are having on the efficiency and operational risk profile of the insurance industry – and ultimately on the affordability and suitability of insurance covers for individuals. The Inquiry notes its support in further exploring ways to resolve issues impeding the rationalisation of legacy products. It asks for comments on the value of reopening discussions on the rationalisation framework proposals consulted on in 2009. It also comments that any related taxation relief issues should be considered in the Tax White Paper process. We think this is an important topic for the industry to remain focussed on, particularly life insurers with legacy product sets.

Lenders mortgage insurance (LMI) — The report does not make extensive comments on the LMI sector, although it does acknowledge its role and influence across insurance, banking and the residential lending markets and will undertake further analysis in the next phase.

A number of the topics covered in this document that span the broader financial services industry are also very important for the insurance industry. In particular:

- Financial advice, disclosure and literacy developments for some segments of the insurance industry will be important in improving the access to affordable and appropriate levels of insurance cover for individuals
- With the increased use of technology and new information sources to manage customer relationships, value propositions and pricing by insurers, any regulatory developments in this area will be important for the industry
- Consideration of the appropriate balance of regulatory impost and options for deregulation is important in the context of the increasing globalisation of the insurance industry, ensuring the local industry remains competitive in this light.

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