Response to the Final Report of the Financial System Inquiry

March 2015

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Customer Owned Banking Association Limited ABN 98 137 780 897

Who we are

Customer owned banking is banking that gives back – to Australian families and their communities. More than four million Australians bank with a customer owned bank, credit union or building society.

We bring a fundamentally different model to the market, a model where customer interests are not in conflict with shareholder interests.

Collectively the sector has $91.9 billion in assets and has the largest share of the household deposits market outside the four major banks.

Customer-owned banking is a major employer and contributor to local communities, with a strong footprint in regional Australia.

The sector has a growing asset base and is the consistent industry leader in customer satisfaction.

Customer-owned banking institutions have a national, regional or local focus or serve communities in education, police, defence, indigenous Australia or particular industries and employers. Large or small, customer owned banking institutions offer responsible, ethical and community focused banking services.

1 Executive Summary

The Financial System Inquiry Final Report lays out a blueprint to promote efficiency and competition, strengthen resilience and enhance consumer trust in the Australian financial system.

It is a blueprint that should be implemented without delay. The current regulatory settings have stifled competition and let down consumers.

We have had the debate, the verdict is in, it is now time to act.

A strong and decisive Government response is needed because of what is at stake: a more dynamic, innovative and consumer-friendly financial system.

COBA urges the Government to seize the opportunity that has been presented by the high-calibre FSI panel. The Government should respond quickly and positively to the report's key priorities and should send a strong signal to all stakeholders to get on board.

1.1 Regulator buy-in

It is crucial that the key regulators – APRA, ASIC and the RBA – buy in to the reform agenda because the FSI has placed a high level of trust in the regulators and has found that while they "often have a difficult task, there is room for improvement."

The Government's strong public endorsement of the recommendations on bank capital is particularly important because implementation of these recommendations is the responsibility of APRA. APRA's response, particularly to FSI Recommendations 1 and 2, is a test of the banking regulator's commitment to competition.

The recommendations on capital, in particular Recommendation 2 on mortgage risk weights, will improve resilience and promote competition.

> "In the Inquiry's view, the relative riskiness of mortgages between IRB and standardised does not justify one type of institution being required to hold twice as much capital for mortgages than another. This conclusion is supported by the findings of APRA's recent stress test, which found regulatory capital for housing was more sufficient for standardised banks than IRB banks."

The FSI concluded that because mortgages make up a significant portion of the assets of almost all Australian ADIs, competitive distortions in this area could have a large effect on their relative competitiveness.

> "This may include inducing smaller ADIs to focus on higher-risk borrowers. Restricting the relative competitiveness of small ADIs will harm competition in the long run."

> "ADIs that use the standardised risk-weight model strongly support narrowing the difference between IRB and standardised mortgage risk weights. These ADIs argue they are at a considerable competitive disadvantage. In some cases, these ADIs

> contend that, without change, they will be forced out of the market — materially lessening competition."

1.2 Rebuilding consumer trust

The FSI has issued a more general warning that high concentration and trends towards increasing vertical integration in some sectors of the financial system have the potential to limit competition in the future.

A sustainably competitive retail banking market is vital for the wider economy but is also critical to providing genuine choice for consumers to allow for the rebuilding of consumer trust in our financial sector.

A healthy, vigorous retail banking market needs customer-owned banking institutions and regional banks, as well as major banks. Diversity of business models is good for stability and competition.

Customer-owned banking brings a fundamentally different model to the market, a model where customer interests are not in conflict with shareholder interests.

The FSI Final Report says that more than 80,000 consumers have been affected by failures such as Storm Financial, Opes Prime, Westpoint, agribusiness schemes and unlisted debentures. Losses from these failures totalled more than $5 billion.

Since those failures, a string of major scandals have been uncovered in the financial advice businesses of the pillars of Australia's financial system.

Senator John Williams told the Senate on 10 February 2015:

> "CBA has identified 400,000 people who could have received shoddy advice. Macquarie Bank is writing to some 160,000 people. We are talking about more than half a million Australians who may have received bad advice."

Senator Deborah O'Neill told the Senate on 10 February 2015:

> "Individuals' lives were ruined and, sadly, some of the largest institutions in this country were implicated."

In recent weeks, new issues have to come light with NAB's financial planning business and with subsidiaries of CBA, Westpac and NAB in relation to advice about complex structured investment products.

Australian consumers deserve better than this.

1.3 Sound implementation

The FSI blueprint is intended to enhance the confidence and trust that users of financial products and services have in the financial system by creating a regulatory environment in which financial firms treat their customers fairly.

Releasing the FSI Final Report in December, Treasurer Joe Hockey observed:

> "When there is confidence and stability in the financial system, we create conditions where investment can thrive and Australians have confidence that their future is secure."

The FSI recommendations on resilience, particularly recommendations 1 and 2, and on consumer outcomes should be given the highest priority for implementation.

Sound implementation will require an appropriate framework. COBA suggests the creation of an Implementation Taskforce within Treasury, supported by a high-level committee including APRA, ASIC, the RBA, PM&C and the Department of Finance. The Implementation Taskforce would be further complemented by the establishment of a Business Advisory Forum, with representatives from industry, peak bodies and other non-government stakeholders.

2 COBA Recommendations

COBA recommendation 1	That the Government delivers its response to the FSI Final Report no later than 30 June 2015
COBA recommendation 2	That the Government response includes a clear and unambiguous statement to APRA regarding the capital recommendations, including implementation timeframes
COBA recommendation 3	That APRA implements FSI recommendation 2 (risk weights) within six months of the Government delivering its FSI response
COBA recommendation 4	That an interim response to FSI recommendation 1 (capital levels) be put in place by APRA within twelve months of the Government delivering its FSI response
COBA recommendation 5	That APRA be required to implement other capital recommendations (FSI recommendations 3, 4 and 7) in timeframes consistent with international developments
COBA recommendation 6	That the Government scraps the proposed deposit levy, consistent with the FSI's recommendation. To provide industry with certainty, announcement of this should be made no later than the 2015 Budget.
COBA recommendation 7	That the Government prioritises the implementation of the FSI's key regulator accountability and consumer protection recommendations. Implementation of these recommendations (FSI recommendations 23, 25, 27 and 30) should be completed by 30 June 2016

Note: See Chapter 7 for a summary list of COBA's position on each of the FSI recommendations addressed in this submission

3 Implementation

The FSI has made a wide range of recommendations designed to improve the overall operation of Australia's financial sector. As the Government's latest Intergenerational Report noted, the FSI "found room for improvement" in regulation of the Australian financial sector, and that the Report's recommendations are "…designed to foster an efficient, competitive and flexible financial system that is capable of meeting future challenges."[1] Given that the financial sector is Australia's largest industry sector, and given the importance of this sector to the rest of the Australian economy, the implementation of these productivity enhancing and pro-competition reforms should be a top priority for the Government.

The FSI spent a year carefully considering the issues and listening to stakeholder feedback before reaching its well-considered conclusions. As such, we do not see the need for a further round of extensive consultation before moving to implementation. Further delays will only see the current imbalances grow more entrenched, with the unfair regulatory settings allowing the major banks to keep increasing their market share. This will continue to put pressure on smaller players, potentially further increasing their funding costs, with detrimental implications for competition, consumer choice and innovation.

COBA notes that the Treasurer has indicated that APRA should be responsible for implementing the capital recommendations made by the FSI, saying that "Several of the Inquiry's recommendations, including those on bank capital and the payment system, are for APRA and the RBA to consider as independent regulators. The regulators will consider recommendations relevant to their mandates."[2]

While COBA recognises the importance of allowing APRA to operate independently as the prudential regulator, we would be concerned if APRA was to be given sole discretion over how, when and if to implement these critical elements of the FSI's recommendations.

There have already been some indications that APRA is in no rush to respond to the FSI recommendations, including one media report that APRA's Chair Wayne Byres has made a private pledge to the ABA "…to put the financial system inquiry's key recommendations on ice pending a new global review of bank capital levels…"[3] With this Basel Committee review unlikely to be completed before the end of 2015 at the earliest, waiting on the outcomes of this before acting could delay implementation by a number of years.

The Australian Bankers' Association (ABA) and Business Council of Australia (BCA) have both publicly expressed support for delayed implementation. The ABA has said that there is a strong argument in favour of "waiting to see where this international process is going before government makes any definite decision on what to do with the Murray recommendations,"[4] and the BCA's view is that "recommendations to lift bank capital ratios and IRB risk weightings would appear to impose costs on the economy for benefits

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[1] Treasury, *2015 Intergenerational Report*, March 2015, p. 96.
[2] Treasurer, *Release of the Financial System Inquiry Report,* 7 December 2014
[3] The Australian, *Banking sector welcomes APRA's shift in tone,* 19 February 2015
[4] Australian Financial Review, *Australian banks call time out on capital level rules,* 23 January 2015

that are not clearly defined and hence need further discussion."[5] Given that these recommendations are designed to force the major banks to operate on a more level playing field, it is unsurprising that these groups would seek to delay the implementation of these recommendations for as long as possible.

The approach to implementation taken to date by APRA contrasts with the RBA, where the payments system regulator has already commenced consultation on relevant recommendations made by the FSI.

APRA should be given a clear and unambiguous signal from Government that it needs to act in a timely fashion on the implementation of these recommendations, and that delaying their implementation, subject to the outcomes of an uncertain global policy development process, is unacceptable. Such a message, preferably conveyed publicly in writing, would in no way undermine APRA's capacity to implement the policy recommendations in line with its legislative mandate. The Government statement should also include a proposed timeframe for responding to the recommendations on capital.

We are concerned that APRA may not give due regard to competition considerations when implementing these recommendations. While APRA's mandate requires them to consider competition and competitive neutrality, it is questionable whether APRA has given due weight to competition considerations. The FSI found that "Policy makers and regulators need to take increased account of competition when making regulatory decisions…"[6] and has made a number of recommendations designed to encourage regulators to give greater weight to competition. It is unlikely that the FSI would have reached these conclusions if it felt that the regulators were already performing well in this regard. As such, there is a risk that APRA could choose to respond to the capital recommendations in an overly cautious fashion without giving due regard to the competition benefits that would flow from their full implementation.

We are particularly concerned about APRA's appetite to implement the recommended changes to IRB risk weights. The FSI Report said that "In the Inquiry's view, the relative riskiness of mortgages between IRB and standardised does not justify one type of institution being required to hold twice as much capital for mortgages than another,"[7] and called for the disparity to be addressed. However APRA's view in its initial submission to the FSI was that it "…does not see any compelling reasons to depart from the Basel II framework, now well-established globally, to seek to deal with residual competition issues in housing lending."

The timely implementation of the capital recommendations made by the FSI will be an important test of APRA's commitment to competition.

In order to ensure that implementation of the FSI's recommendations is progressed in a timely fashion, we recommend that the Government work towards the following timeframes.

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[5] Business Council of Australia, *Government's response to Financial System Inquiry must prioritise growth and jobs,* 7 December 2015
[6] Murray, *FSI Final Report*, November 2014, p. 237.
[7] ibid., p. 61.

Firstly, the Government should adopt recommendation 6, and abandon the deposit levy, with an announcement to be made no later than the 2015 Budget. With the levy currently scheduled to take effect from 1 January 2016, it is important that the Government declares its position on this issue as a matter of urgency to provide industry with certainty.

Secondly, the Government should formally respond to the FSI Final Report by the end of June 2015. This will give the Government seven months between the receipt of the Final Report and the release of its response. It will also provide the Government with three months to consider stakeholder submissions. Given that the whole FSI was completed in less than a year, seven months is an adequate timeframe in which to deliver a response.

The Government's response to the FSI Report should include a clear and unambiguous statement to APRA regarding the capital recommendations. This should include a requirement that APRA implement each of the capital recommendations within specified timeframes. We would recommend that:

- Recommendation 2 be implemented by APRA within six months of the Government response being released (i.e. by 31 December 2015);
- That an interim response to recommendation 1 should be put in place by APRA within twelve months of the Government response (i.e. by 30 June 2016); and
- That APRA implement the other capital recommendations (i.e. recommendations 3, 4, and 7) in a timeframe consistent with international developments.

The Government response should also include a commitment to implement the key regulator accountability and consumer protection recommendations by the end of the 2015-16 financial year. COBA believes that the highest priority should be given to progressing recommendations 27 and 30 in the "regulatory system" space, and recommendations 23 and 25 in the "consumer outcomes" space.

Box 2 - The Importance of Competition and competitive neutrality

Competition is an essential element of efficient markets, and without adequate competition, consumer outcomes suffer, in terms of both price and choice. While the home loan market is undoubtedly highly competitive at the moment, institutions are clearly not competing on a level playing field and the current situation is unsustainable. If the imbalances are not addressed, the major banks will be able to continue expanding their market share at the expense of other ADIs, undermining the level of competition in the longer term.

In commenting on the FSI and the importance of competition, Treasury Secretary John Fraser recently noted that:

"The importance of strengthening competition was also a theme of the Financial System Inquiry. The Inquiry concludes that competition and competitive markets are at the heart of the philosophy of the financial system and the primary means of supporting the system's efficiency. We must ensure that our banking and financial system are generally more competitive."

Similarly, ACCC Chair Rod Sims stated that:

"Late last year, the Murray Report identified competition as one of the main areas where there is significant scope to improve the functioning of the financial system.

"In the financial sector there is always a tension between financial regulators focusing on prudential and competition issues. Murray wants more focus on the latter.

"The ACCC, of course, welcomes this. While we have four major banks competing against each other, this sector would be more dynamic and bring more benefits to consumers if there could be more competitive pressure brought on the four major banks.

"No matter how many competitors there are, stable oligopolies do not yield the best results. Markets need to be constantly and fully contestable."

For competition to be effective in delivering positive outcomes, it must also be sustainable. Competitive neutrality is a critical element in delivering sustainable competition.

The Productivity Commission describes the competitive neutrality principle as sellers of goods and services competing on a level playing field; that is, one provider should not receive an advantage over another due to government regulation.

"Competitive neutrality removes artificial advantages and allows businesses to compete on a basis that offers the best cost and quality combinations to customers. This is likely to result in more effective competition and more efficient outcomes."[8]

Competitive neutrality does not require identical rules and regulations for all banking institutions. Rather, it requires a principles-based regulatory framework that allows for diversity and recognises the benefits for consumers and overall system stability of accommodating different business models.

The head of the RBA's Financial Stability Department, Luci Ellis, commenting on regulatory consistency, has observed:

"….in ensuring consistency, we do not want to create a monoculture, with all its members being vulnerable to the same risks because they face the same incentives. There is something to be said for allowing some diversity of business models, so the whole system doesn't collapse from a particular shock."[9]

Competitive neutrality means the customer-owned model should be able to compete on equitable terms with the listed model, without being handicapped by unfair treatment and/or subsidies to competitors.

Competitive neutrality is vitally important in the Australian banking market. It does not currently exist.

The FSI has put forward recommendations designed to help address the current imbalance in regulatory settings; it is now imperative that the Government move quickly to implement them. In the absence of positive action by Government and regulators, the major banks' grip on the banking sector will only tighten further, and competition will be further eroded.

[8] Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010
[9] Luci Ellis, *Stability, Efficiency, Diversity: Implications for the Financial Sector and Policy,* 18 October 2013

4 Resilience

4.1 Overview

The FSI Final Report makes a total of eight recommendations regarding financial sector reliance. As a package, these recommendations are designed to:

"…enhance the resilience of the Australian financial system, which underpins the strength and efficiency of the economy. The recommendations seek to make institutions less susceptible to shocks and the system less prone to crises, reducing the costs of crises when they do happen, and supporting trust and confidence in the system. They aim to minimise the use of taxpayer funds, protect the broader economy from risks in the financial sector and minimise perceptions of an implicit guarantee and the associated market distortions."[10]

With respect to the banking sector, the resilience recommendations are designed to "…reduce the probability of failure and minimise the cost of failure when it does occur…"[11]

The Report correctly identifies the critical importance of financial sector resilience, and the significant economic consequences that flow from a financial crisis. As the Report notes:

> "…international experience suggests the average financial crisis could see 900,000 additional Australians out of work as well as substantially reduce the wealth of a generation. Financial crises tend to be protracted, with unemployment remaining high for years. The average total cost of a crisis is around 63 per cent of annual gross domestic product (GDP), and the cost of a service crisis is around 158 per cent of annual GDP ($950 billion to $2.4 trillion in 2013 terms)."[12]

Similarly, the Government's latest Intergenerational Report notes that:

> "The onset of the Global Financial Crisis pushed the Irish economy into a recession and brought an end to its housing boom. Irish banks required substantial Government support, in turn increasing the public debt burden. This alongside a fall in revenues saw a rapid increase in Irish gross debt between 2008 and 2013. … Ireland's experience provides a cautionary warning for all governments. Government balance sheets can deteriorate rapidly in the face of large economic shocks, especially when public finances are exposed to contingent liabilities in the financial sector."[13]

Given the massive economic costs of a financial crisis, the government should do all that it can to reduce the risk of a crisis as much as it sensibly can. While there are some costs associated with the implementation of these recommendations, these costs are more than offset by the benefits they provide in terms of improved financial security and stability.

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[10] Murray, *FSI Final Report*, November 2014, p. 35.
[11] ibid., p. 36.
[12] ibid., p. 33.
[13] Treasury, *2015 Intergenerational Report*, March 2015, p. 54.

These recommendations also provide a broader benefit to society to the extent that they reduce the magnitude and strength of the Government's implicit guarantee of the major banks. This reduces the likelihood of taxpayers finding themselves "on the hook" in a future financial crisis, and also reduces the moral hazard and mis-allocation of resources that the implicit guarantee encourages.

As the FSI Report notes: "…implicit guarantees create market distortions, altering the risk-reward equation and conferring a funding cost advantage on financial institutions perceived as guaranteed."[14]

Aspects of the resilience recommendations will also help to level the playing field between standardised and IRB ADIs, and between large and small banking institutions. The positive impact that these recommendations will have on competition, competitive neutrality, and consumer outcomes should not be overlooked.

4.2 Capital Levels

FSI Recommendation: Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong (recommendation 1)

This recommendation is designed to achieve several policy objectives:

- Reduce the risk of a financial crisis in Australia;
- Mitigate the distortions created by the implicit government guarantee; and
- Reduce the amount of moral hazard currently in the Australian banking sector.

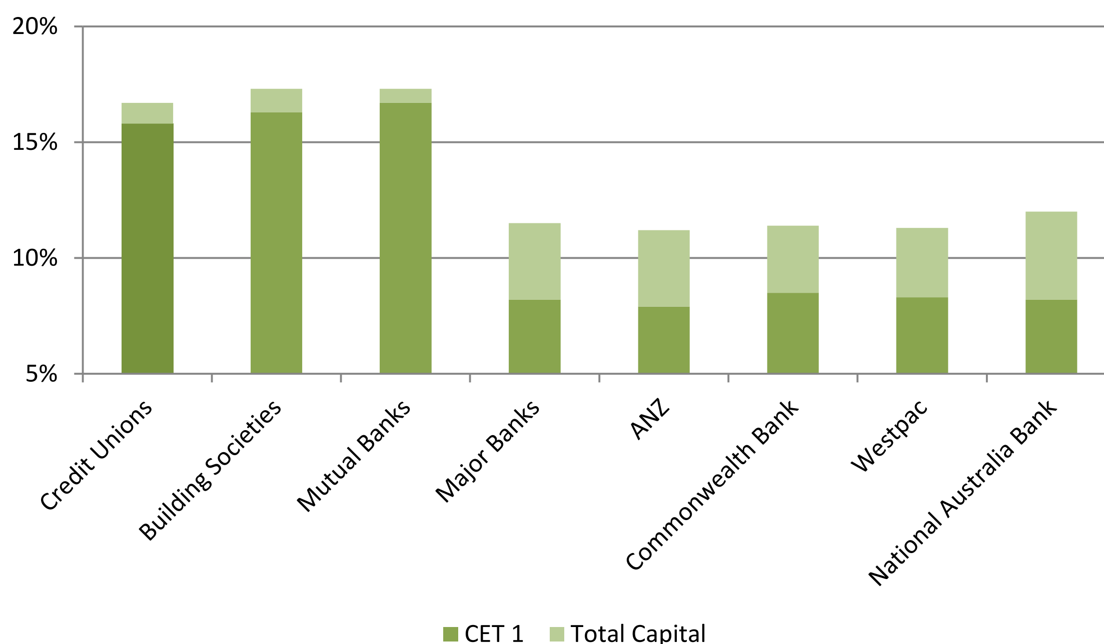
These are all valuable policy objectives and COBA recommends that the necessary changes be implemented without delay.

As has already been noted, the costs of a financial crisis would be significant.

COBA supports the FSI's objective of ensuring that all ADIs hold levels of capital that are unquestionably strong, and the application of this requirement to all ADIs. However, we note that any capital shortfalls are likely to be most pronounced for the major banks. Reflecting the prudent and risk-averse nature of our sector, customer owned banking institutions already hold capital levels that are on average far higher than those adopted by other ADIs.

[14] Murray, *FSI Final Report*, November 2014, p. 33.

***Chart 1 - Capital Adequacy*[15]**



CET 1 capital levels for customer owned ADIs are almost twice as high as those of the major banks. Furthermore, if the major banks were required to use the same risk weights as other ADIs, their reported capital ratios would be even lower.

The differential in capital positions was reinforced by APRA's 2014 stress test of the banking sector, where APRA found that "…regulatory capital for housing held by standardised banks was (just) sufficient to cover the losses incurred during the stress period, that was not the case for IRB banks."[16]

How much additional capital

In determining what should be considered "unquestionably strong," the FSI Report has stated that "A baseline target in the top quartile of internationally active banks in recommended."[17]

Difficulties around international capital comparisons mean that it is difficult to tell how far the major banks currently fall short of this benchmark. In this regard, the FSI Report has also recommended that APRA should "Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework."[18]

While COBA supports this recommendation, we do not believe that the additional reporting obligation should be applied to smaller ADIs which are already well above the international benchmark. The FSI appears to have reached a similar position, suggesting that "APRA

[15] Source: APRA, Quarterly ADI Performance, Dec 2013; Major Bank Basel III Pillar 3 Disclosures, Dec 2013
[16] APRA, *Seeking Strength in Adversity: lessons from APRA's 2014 stress test on Australia's largest banks,* Nov 2014, p, 8.
[17] Murray, *FSI Final Report*, November 2014, p. 41.
[18] ibid., p. 76.

should consider whether reporting should be voluntary to avoid imposing costs on those banks for which it would serve no benefit."[19]

While there is some disagreement about how far below the international benchmark the major banks currently sit, the fact that they fall short of this benchmark to at least some degree is generally accepted.

The FSI Report notes that the global 75th percentile is currently 12.2%, and the "plausible range" of major bank CET1 capital ratios is 10.0%-11.6%,[20] implying a current capital shortfall in the range of 0.6%-2.2%. While a PricewaterhouseCoopers report found that the major banks had an "Internationally comparable CET1 ratio" of 12.7%,[21] the FSI Report found that the methodology was "not a plausible basis for international comparison."[22]

We also note that, in the absence of any positive action by regulators in this space, the gap between the major banks and their global peers is likely to increase over time. Basel III was rolled out more aggressively in Australia than in many other countries, meaning many of the required capital adjustments have already flowed through the Australian banking sector. In contrast, significant changes are continuing to be rolled out by our international peers, and banking capital levels in these jurisdictions are still likely to increase significantly. The FSI Report notes that "…many countries are still 'catching up' with their implementation of Basel III relative to Australia…" and that "it can be expected that the global distribution of capital levels will therefore continue to rise for some time yet."[23] This impact should not be underestimated; the most recent Basel Committee on Banking Supervision (BCBS) assessment (covering the first half of 2014) found that the 75th percentile had increased from 12.2% to 13.3% in the months since the publication of the FSI Final Report.[24] Failure to act on this recommendation in a timely fashion will result in the major banks falling further behind their international peers.

While we accept that a final calibration of this benchmark will be dependent on the successful implementation of internationally comparable reporting by Australian ADIs, this does not mean that no action should be taken to address the current imbalance in the interim. Given that the major banks have the lowest capital adequacy levels amongst Australian ADIs, and given the general acceptance that they currently fall below the international benchmark put forward by the FSI, it would be sensible to consider a temporary additional capital buffer for the major banks as an interim measure.

COBA believes that the simplest and most effective way to achieve this outcome would be to increase the D-SIB capital buffer, which is currently set at 1 per cent. The D-SIB surcharge is an existing mechanism which can be used to easily adjust D-SIB capital levels in a consistent and transparent fashion. The current D-SIB surcharge applied in Australia is well below the 75th percentile when compared to our international peers, and is in fact "at the low end of the international spectrum…"[25] Using the D-SIB surcharge as an interim

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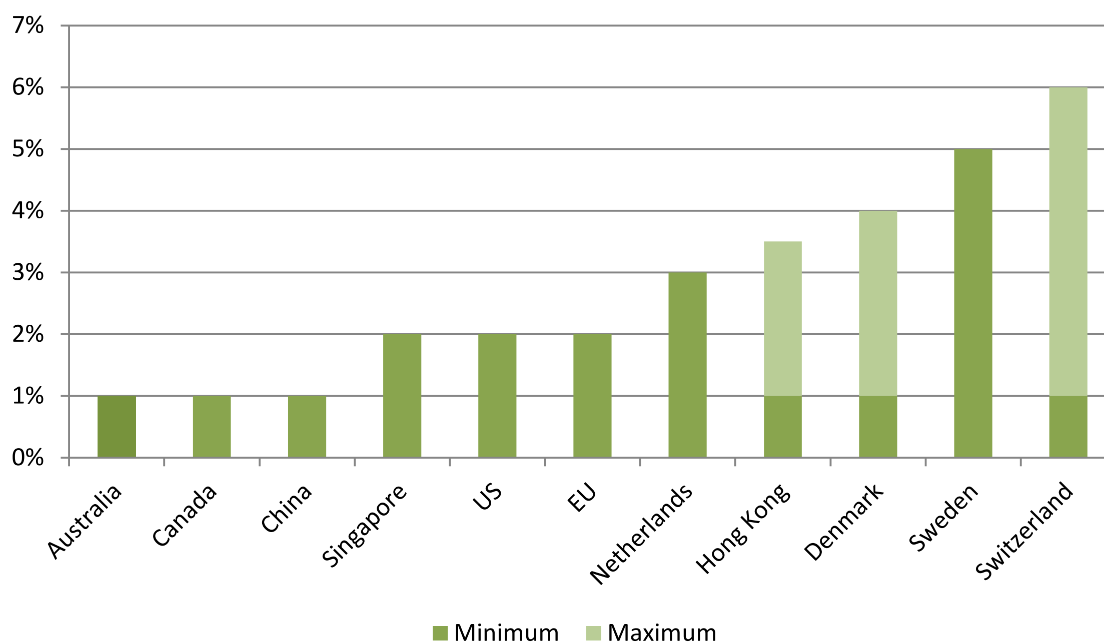
[19] Murray, *FSI Final Report*, November 2014, p. 78.
[20] ibid., p. 49.
[21] PricewaterhouseCoopers, *ABA: International comparability of capital ratios of Australia's major banks,* August 2014, p. 20.
[22] Murray, *FSI Final Report*, November 2014, p. 50.
[23] ibid.
[24] Basel Committee on Banking Supervision, *Basel III Monitoring Report,* March 2015
[25] Murray, *FSI Interim Report,* July 2014, Chap 3 p. 15.

measure will mean a less dramatic transition once the appropriate capital benchmark is derived.

In March 2015, Hong Kong's Monetary Authority announced that five banks had been designated as D-SIBs, with only one of the five given the minimum additional capital surcharge of 1 per cent. Three of the banks were given a capital surcharge of 1.5 per cent and one bank was given a surcharge of 2.5 per cent, to be phased in by January 2019.[26]

Chart 2 – D-SIB responses in other countries[27]



In considering the interaction between recommendation 1 and the D-SIB capital buffer, the FSI report notes that the introduction of a higher capital base for all ADIs (through the implementation of recommendation 1), "…may reduce the need for further changes to the D-SIB buffer."[28]

By the same rationale, a temporary increase in the D-SIB capital buffer would reduce the need to move quickly on the implementation of recommendation 1. As the FSI Interim Report notes, "Increased capital requirements are in line with international practice," and increasing the D-SIB buffer "…also helps ameliorate the effects generated by perceptions of an implicit guarantee."[29]

We also note that the D-SIB buffer plays an important role pushing back against the cost of funds advantage that systemically important financial institutions enjoy through being "too big to fail."

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[26] Hong Kong Monetary Authority, *Designation of Domestic Systemically Important Authorized Institutions,* March 2015.
[27] Source: FSI, APRA
[28] Murray, *FSI Final Report*, November 2014, p. 59.
[29] Murray, *FSI Interim Report*, July 2014, Chap 3 p. 15.

COBA therefore recommends that:

- APRA progresses implementation of Recommendation 4, and develops a reporting template that allows for international comparisons of capital levels;
- Australian ADIs be benchmarked against the 75th percentile internationally once recommendation 4 is implemented; and
- As an interim measure, Australia's D-SIB surcharge be increased to at least 2 per cent, with the surcharge reverting to 1 per cent once the 75th percentile benchmark is in place.

4.3 Risk weights

FSI Recommendation: Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights (recommendation 2)

This recommendation is primarily directed at addressing the competitive imbalance created by the differing regulatory treatment of standardised and IRB ADIs. Under the current regulatory arrangements, IRB ADIs (the four major banks and Macquarie Bank) are able to use internal models to calculate risk weights, while standardised ADIs (all other ADIs) are required to calculate risk weights using the standardised approach. Residential mortgages attract significantly higher risk weights under the standardised approach. As the FSI report notes, "The gap between average IRB and standardised mortgage risk weights … translates into a funding cost advantage."[30]

This gap is significant; the average risk weight for an IRB residential mortgage is 18 per cent, while for standardised ADIs the average risk weight is twice as high (39 per cent).[31] This imbalance is having a detrimental impact on the Australian banking sector. As the FSI Report notes:

> "Given that mortgages make up a significant portion of the assets of almost all Australian ADIs, competitive distortions in this area could have a large effect on their relative competitiveness. This may include inducing smaller ADIs to focus on higher-risk borrowers. Restricting the relative competitiveness of small ADIs will harm competition in the long run."[32] And that "In some cases, these ADIs contend that, without change, they will be forced out of the market – materially lessening competition."[33]

Similarly, FSI Panel member Kevin Davis noted that:

> "Significant distortions in competitive ability have occurred, particularly in domestic housing mortgage markets. This is a paradoxical outcome, given that the IRB approach was premised on levelling the playing field for large banks operating in

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[30] Murray, *FSI Final Report*, November 2014, p. 61.
[31] ibid., p. 65
[32] ibid., p. 61.
[33] ibid., p. 63.

> international markets, but has had the largest impact on risk weights on purely domestic activities and adverse consequences for smaller domestic banks."[34]

More broadly, a range of concerns have been raised about the appropriateness of the IRB approach, with a number of regulatory bodies suggesting a lack of confidence in the results being generated by the internal models being used by these banking institutions.

For example, in a speech delivered last September,[35] APRA Chair Wayne Byres said there was an increasing lack of faith in the use of internal models for calculating risk weights and their future "is somewhat in the balance." Mr Byres went on to say that "Unless investors have faith in the resulting risk-based capital ratios, they do not serve their full regulatory purpose. And if that is the case, simpler metrics will inevitably become more important – and potentially even binding."

Similarly, the BCBS has said that, under the IRB approach "…there are material variances in banks' regulatory capital ratios that arise from factors other than differences in the riskiness of banks' portfolios," and that "These variances undermine confidence in capital ratios."[36]

It is arguable that the current approach allows IRB ADIs to use modelling assumptions which produce risk weights which are too low, and which result in IRB ADIs holding inadequate amounts of capital. As noted previously in this submission, APRA's recent stress test found regulatory capital held by IRB ADIs insufficient to cover the losses incurred under the scenario. Introducing a risk weight floor for IRB ADIs will help to mitigate this risk and enhance financial sector stability.

In addition to positive outcomes for financial stability, the adoption of an IRB risk weight floor would rectify a significant competitive imbalance in the Australian banking sector. Addressing this regulatory distortion in a timely fashion is essential to ensure continued diversity in Australia's banking sector, while failure to act now will result in greater concentration and further undermine banking sector competition.

The recommendation on risk weights will enable customer-owned banking institutions and regional banks to apply sustainable competitive pressure to the major banks in the home loan market. A floor will remove the major banks' capacity to unfairly undercut competitors on the lowest-risk mortgages.

Narrowing the gap between the two approaches is a sensible policy response to the current distortions, and seeks to "improve the competitive neutrality of capital regulation by limiting distortions caused by the differential regulatory treatment of different classes of ADIs."[37]

While this could be achieved by either increasing the IRB rate or lowering the standardised rate, we note that increasing the IRB floor will increase overall levels of capital in the banking system and is therefore both a pro-competition and pro-stability measure.

[34] Australian Centre for Financial Studies, *Basel 3++: Buttons, Belts and Braces,* January 2015, p. 4.
[35] Wayne Byres, *Perspectives on the Global Regulatory Agenda,* 16 September 2014
[36] Basel Committee on Banking Supervision, *Reducing excessive variability in banks' regulatory capital ratios,* Nov 2014, p. 1.
[37] Murray, *FSI Final Report*, November 2014, p. 60.

Australia would be far from alone if it was to implement a policy change of this kind. As the FSI Final Report notes, "Other countries have also placed restrictions on IRB mortgage risk weights through a number of means. For example, Sweden, Hong Kong and the United Kingdom have all used or proposed a mortgage risk-weight floor of 15-25 per cent. New Zealand has made a number of changes to the Basel-specified parameters for IRB models. Norway will introduce a 20 per cent floor on the loss given default parameter…"[38]

In addition to creating a more level playing field, increasing IRB risk weights will result in other positive outcomes. For example, placing a floor on residential mortgage risk weights will improve the relative attractiveness of other forms of lending, and encourage major banks to direct a greater proportion of their lending to other activities. This would help to reinforce the current activities of the RBA and APRA which are directed at ensuring growth in residential mortgage lending does not become unsustainable. It would improve the relative attractiveness of SME lending to the major banks and encourage them to conduct more business in this area.

In considering the imposition of an IRB floor, the FSI Report states that "The Inquiry considers a range between 25 and 30 per cent to be appropriate, to be decided on by APRA in targeting an average IRB mortgage risk weight."[39] This would be significantly higher than their current average mortgage risk weight of 18 per cent.[40]

The FSI Report estimates that the amount of additional capital IRB ADIs would need to hold to meet this higher standard would be roughly equivalent to a 100 basis point increase in their CET1 capital ratio. As the report notes, "This corresponds with a small funding cost increase for the major banks."[41]

Any changes made to IRB risk weights will only affect five ADIs. The vast majority of ADIs will continue to use the standardised model, and will not be impacted by the introduction of an IRB risk weight floor. This will significantly constrain the capacity of IRB ADIs to pass on the costs through higher prices. The FSI Report agrees, and finds that: "Competition will limit the extent to which this cost is passed on to consumers, and shareholders will likely bear some of the cost in the form of a lower ROE."[42] Similarly, in announcing the release of the FSI Report, David Murray noted that "…the recommendation on the risk weights … should not have an effect on interest rates because it's meant to remove a competitive distortion in the system."[43]

While we acknowledge that the BCBS is currently considering possible changes to standardised risk weights, this is no reason to delay implementation of this recommendation. At this stage, the BCBS proposals are only proposals, and there is no guarantee that any changes in this space will eventually be agreed to by the Basel Committee. Even if changes are adopted, it will be a number of years before the work of the BCBS is finalised and implemented in Australia. The competition imbalances which result from the current regulatory settings are real, and are leading to undesirable outcomes now. Action is needed now.

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[38] Murray, *FSI Final Report*, November 2014, p. 64.
[39] ibid., p. 65.
[40] APRA, *Second Round Submission to the FSI*, 2014, p. 9.
[41] Murray, *FSI Final Report*, November 2014, p. 64.
[42] ibid., pp. 64-65.
[43] Treasurer, *Press Conference – Release of FSI Report,* 7 December 2014

We also note that the changes proposed by the BCBS are likely to increase the overall risk weight applied to residential mortgages under the standardised approach. If these changes were implemented in Australia without addressing FSI recommendation 2 then the gap between the IRB and standardised approaches would become even larger, an outcome completely contrary to that sought by the FSI.

The main purpose of introducing an IRB floor is to address a regulatory distortion which is undermining competitive neutrality in our domestic banking sector. There is no reason to delay the implementation of this recommendation to incorporate the as yet unknown outcomes of an international review aimed at better global harmonisation of risk weights.

Given there is broad agreement that the IRB approach is not working, and that there is a simple solution which would go some way to addressing the problem, there is no reason to delay. There is no barrier to introducing a temporary IRB risk weight floor now, and then to adjust this floor if warranted once the work of the BCBS is concluded.

We note that some stakeholders have recommended that instead of narrowing the risk weight gap, barriers to IRB accreditation should be reduced. This idea has merit but the fact is a significant number of ADIs will always lack the size and scale necessary to make IRB accreditation an economic option. For this reason, it is critical that policy changes be made to narrow the risk weight regardless of any changes APRA may choose to make to the IRB accreditation process.

4.4 Financial Claims Scheme

FSI Recommendation: Maintain the ex-post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions (recommendation 6)

In August 2013, the introduction of a deposit levy was announced by the previous Labor Government. The levy was to be set at five basis points "on average,"[44] and would be applied to all Financial Claims Scheme (FCS) protected deposits from 1 January 2016 (i.e. the second half of the 2015-16 Budget year).

The Government has not made a definitive statement on its intentions with respect to this proposal since its election in September 2013, but has stated that its final position will be determined "…subject to the outcomes of the Financial System Inquiry…"[45]

The FSI has explicitly rejected the proposed deposit levy, and instead recommended that the Government "Maintain the ex-post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions."[46]

In reaching its conclusion on the FCS deposit levy, the Report noted a number of characteristics of the Australian banking sector that make the imposition of a levy here less appropriate than in other countries. In particular, the FSI observed that:

- "…Australia's depositor preference arrangements reduce the risk of an ADI's assets being insufficient to meet insured deposits…";

[44] Bowen, *Press Conference – Economic Statement,* 2 August 2013
[45] Treasury, *2014-15 Budget*, May 2014, BP1-BS8, p. 14.
[46] Financial System Inquiry, *Final Report,* November 2014, p. 82.

- Implementation of the FSI's other recommendations "…would further strengthen the resilience of the Australian banking sector by reducing the risk of failure and mitigating the costs of failures that do occur"; and
- The crisis management consultation package "…includes a number of measures designed to strengthen the FCS and Government's ability to recoup costs."

These factors virtually eliminate the likelihood of the FCS ever being called upon in practice. Accordingly, the FSI formed the view that "…it is preferable to retain an ex-post funding model that avoids placing an ongoing financial burden on the industry."

COBA's previous submissions to the FSI set out our concerns about the deposit levy in some detail, and in particular emphasised that its introduction would have a disproportionate impact on the customer-owned banking sector given our higher reliance on deposits as a source of funding relative to other ADIs. We estimate that this proposed tax on deposits would cost the customer-owned banking sector more than $30 million per year. In this regard, we strongly welcome the FSI's recommendation.

While the Council of Financial Regulators (CFR) had originally recommended the introduction of the deposit levy, more recently the Chair of the CFR – RBA Governor Glenn Stevens – has expressed support for the FSI's recommendation, stating that its proposed approach to the FCS was "eminently logical."[47]

We strongly urge the Government to stand by its earlier commitment to accept the recommendation of the FSI and to not proceed with the deposit levy.

As previously noted in this submission, it is critical that the Government announces its position on this issue in the May Budget, or even earlier if possible. Given the deposit levy is currently scheduled to take effect from 1 January 2016, a timely announcement is essential to provide industry with certainty.

4.5 Loss absorbing and recapitalisation capacity

FSI Recommendation: Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support (recommendation 3)

This recommendation will encourage APRA to apply the G20's work around 'total loss-absorbing capacity' (TLAC) to our major banks – this currently only applies to global systemically important banks (GSIBs).

As the FSI Report notes, one of the objectives of this recommendation is to: "Reduce perceptions that some banks are subject to an implicit Government guarantee…" This is a particularly important recommendation for our sector, as it should reduce the funding cost advantage the major banks enjoy by virtue of a credit rating uplift based on an implicit government guarantee.

[47] Australian Financial Review, *Glenn Stevens interview: the full transcript,* 13 Dec 2014

While the TLAC framework is still under development, the ratings agencies have already flagged the potential impact of the recommendation on major bank credit ratings.

Fitch has said that: "The development of a stronger resolution framework is likely to result in the removal of our view of implicit support for the system…" while Moody's has noted "…that increasing loss-absorbing capacity could place offsetting negative pressure on the current two-notch uplift in the major banks' ratings for senior obligations attributable to government support, since it reduces the likelihood of bank resolution taking place by way of bail-out and instead implies a higher level of burden-sharing with creditors."

While it is likely to be a number of years before this change takes effect, this recommendation has the capacity to significantly reduce the unfair funding cost advantage the major banks currently enjoy thanks to their too-big-to-fail status.

COBA sees this as one of the most important, but also one of the more challenging and complex recommendations of the FSI, and we support the approach of implementing the recommendation in line with emerging international practice.

4.6 Leverage ratio

FSI Recommendation: Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions' risk-weighted capital positions (recommendation 7)

The leverage ratio is designed to address the risk that "…in some instances, the risk weighted approach may lead to insufficient levels of capital." While the FSI Report recommends that a leverage ratio be applied to all ADIs, it also recognises that the risk "…is greatest for IRB models, as there is potential for 'model risk'…" where "…banks may have the capacity – and incentive – to manipulate IRB models to achieve a lower capital requirement."[48]

COBA supports the introduction of a leverage ratio in Australia in line with the Basel framework, and consistent with the approaches of countries like the United States, United Kingdom and Canada, where leverage ratios have already been introduced.

While generally only acting as a backstop, a leverage ratio would nonetheless reduce the capacity of IRB ADIs to achieve excessive leverage through the application of very low average risk weights across their aggregate balance sheet.

4.7 Crisis management toolkit

FSI Recommendation: Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry (recommendation 5)

In commenting on the original 2012 crisis management reform proposals put forward by Treasury and APRA, our submission stated that COBA "strongly supports APRA having appropriate powers to manage a crisis situation in the ADI sector," and that

[48] Murray, *FSI Final Report*, November 2014, p. 85.

"…amendments to Australia's crisis management powers may be appropriate to ensure that APRA remains well placed to deal with any situations that may arise."[49]

Our position on these matters has not changed. COBA supports the resumption of consultation on the crisis management toolkit, and looks forward to commenting further on the specific proposals when further detail is released.

However, COBA sees the implementation of the other resilience recommendations (and in particular those related to current capital imbalances) as a higher priority, and would be disappointed if progressing this recommendation resulted in other aspects of FSI implementation being delayed.

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[49] Abacus, *Submission to Treasury – Strengthening APRA's Crisis Management Powers,* December 2012, p. 1.

5 Consumer outcomes

5.1 Overview

COBA supports these recommendations to enhance the fair treatment of consumers, strengthen the accountability of product issuers and distributors, reduce the risk of significant consumer detriment from unfair treatment, and encourage a customer-focused culture in financial firms.

5.2 Product issuer and distributor accountability

FSI Recommendation: Introduce a targeted and principles-based product design and distribution obligation (recommendation 21)

COBA recognises that this obligation aims to reduce the number of consumers buying products that do not match their needs. We note however that the problem the recommendation seeks to address is primarily a result of large scale financial investment failures, and poor advice, associated with complex, 'Tier 1' financial products.

The Final Report identifies the difference in risk of consumer detriment between complex and simple products, and states "simple low-risk products such as basic banking products would not require extensive consideration, and may be treated as a class with a standard approach to their design and distribution."[50]

COBA is unaware of any incidence of significant consumer detriment associated with the design or distribution of basic banking products. Basic banking products are defined under section 961F of the *Corporations Act 2001* and include basic deposit products (such as transaction accounts), non-cash payment facilities, and travelers cheque facilities.

COBA suggests that should the Government seek to implement this recommendation, the following should be apply:

- A full exemption for basic banking products; and
- Broader 'Tier 2' products should "treated as a class with a standard approach" due to the low level of risk associated with these products.

Lastly, we consider that the proposed model should be simplified so that, rather than two stages of product review (at both the design and distribution stages) there could be just one. The design stage could take into consideration how a product will be distributed, given the target market is already being considered at this initial stage. Product issuers could consult distributors during this phase, and product issuers could provide a product profile outlining recommended distribution channels.

[50] Murray, *FSI Final Report*, November 2014, p. 199.

5.3 Financial adviser competency

FSI Recommendation: Raise the competency of financial advice providers and introduce an enhanced register of advisers (recommendation 25)

Standards for Financial Advisers

COBA members acknowledge the need to address the minimum standards for financial advisers, otherwise known as 'financial planners', who provide advice on 'Tier 1' financial products.

COBA supports Recommendation 25 and accepts that financial advisers should:

- hold a relevant tertiary degree;
- be competent in specialised areas if they provide specialised advice; and
- maintain a level of ongoing professional development.

We wish to note however, that implementing the above standards may pose some difficulties for existing advisers. A vast number of existing advisers, who provide quality advice, are likely to have built up a lifetime of expertise, but do not hold a relevant tertiary degree. COBA recommends that the new requirements:

- be subject to appropriate transition arrangements; and
- incorporate a framework for recognition of prior learning.

Enhanced Register of Financial Advisers

COBA supports the enhanced register of financial advisers and considers that it will provide much needed transparency for consumers.

While the enhanced register will contain information about an adviser's experience and history, it will also importantly display the name of the entity that controls the licensee for which the adviser works. This will assist consumers in identifying advisers who are indirectly employed by large, vertically integrated firms such as the major banks.

The Explanatory Statement to the regulation which enables the enhanced register states:

> *Currently, many financial advice firms are controlled by firms that issue financial products, and consumers are often not aware of a relationship between an advising firm and particular financial products. This lack of transparency about the context of the advice can contribute to a lack of trust in the financial advice industry.*

COBA also notes the benefits of the register to audiences broader than consumers, such as licensees and regulators in monitoring the activities of financial advisers.

5.4 Innovative disclosure

FSI Recommendation: Support innovative disclosure and improve the way risk and fees are communicated (recommendation 23)

COBA supports the removal of regulatory impediments to the development of more innovative types of product disclosure. Doing so is likely to encourage financial services providers to explore new ways of delivering important information to customers.

COBA notes that a good deal of work to progress this recommendation is already being undertaken by ASIC. COBA has provided a response supporting the measures proposed by ASIC in its recent consultation paper 224: *Facilitating electronic financial services disclosures.* COBA sees the initiatives proposed in this paper as:

- Providing significant cost savings to financial services providers through removing requirements to use hard copy disclosure documents as the default method;
- Enhancing customer experience by providing more user-friendly and technologically up-to-date disclosures. We note comments by ASIC's External Advisory Panel that Australia is past the 'tipping point' where "disclosure by electronic means should be the default method of delivery"; and
- Supporting better customer engagement with, and understanding of, disclosure by allowing for the development of innovative and possibly interactive types of disclosures.

COBA members look forward to being able to utilise electronic and increasingly more innovative methods for communicating financial product information with their customers.

5.5 General advice

FSI Recommendation: Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures (recommendation 40)

Renaming General Advice

COBA does not oppose renaming the term 'general advice' but we note that the concept of 'financial product advice', under which the definition of 'general advice' sits in the Corporations Act, is "a recommendation" about a financial product.

Should the term be renamed, care will need to be taken to avoid unintended consequences, as the regulation of the activities of financial services employees naturally flows from the current advice framework. Clarity will be required about the regulatory status of an alternative to 'general advice', such as 'product sales information'.

Disclose of Ownership Structures

COBA strongly supports this recommendation. The recommendation acknowledges that vertical integration of product manufacture and distribution by large financial institutions can be detrimental to consumers seeking independent advice.

The Final Report notes that "Often, consumers do not understand their financial adviser's or mortgage broker's association with product issuers." Further, the Final Report notes a

survey which states that "55% of those receiving financial advice from an entity owned by a large financial institution (but operating under a different name) thought the entity was independent."[51]

COBA supports a requirement for greater transparency of ownership structures and product alignment. We support the Final Report's statement that "disclosures should be broader than Financial Services Guides and Credit Guide rules… and could include branded documents or materials." It is vital that consumers understand who they are dealing with, to empower them and to restore trust in the financial services industry.

COBA urges the Government to implement measures that require disclosure of ownership structures in product branding, including on websites, on shop-fronts and on any official documentation including disclosure documents. Consumers must be aware of broker and adviser linkages to large, vertically-integrated players.

Further, controlling entities of licensees should be required to be better disclosed in all financial services contexts. Consumers should be made aware of the controlling entity behind consumer-facing brands. Major bank 'multi-branding' means that the highly concentrated nature of the banking market is disguised by a proliferation of major bank sub-brands that create an illusion of diversity and choice. Large financial institutions portraying sub-brands as independent competitors continues to be detrimental to competition and we urge the Government to apply the intent behind recommendation 40 to major bank multi-branding.

5.6 Differentiation of ADIs and non-ADIs

FSI Recommendation: Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from ADI deposits (recommendation 35)

COBA strongly supports this recommendation. We note that the Final Report states "…some consumers did not appreciate the difference between finance companies and ADIs," and that "This problem was exacerbated by finance companies using bank account-like terminology and allowing consumers to access funds at call."

COBA notes that APRA is currently taking steps in line with this recommendation. In November 2014, APRA announced that Registered Financial Corporations (RFCs) would not be allowed to offer or accept new at-call accounts from 1 July 2015.

COBA supports the banning of finance companies from offering at call products and using bank account-like terminology.

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[51] Murray, *FSI Final Report*, November 2014, p. 271.

5.7 Credit reporting

FSI Recommendation: Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime (recommendation 20)

COBA supports this recommendation. Industry is currently finalising the self-regulatory framework to facilitate the exchange of more comprehensive credit data. Imposing a mandatory regime at this time is unnecessary, would disrupt the strong progress made by industry, and may disproportionately impact smaller credit providers.

Industry, including a broad range of credit providers both large and small, had called for a comprehensive credit reporting regime for a number of years in the lead-up to the necessary legislative changes in 2014. This demonstrates industry's willingness to participate in a comprehensive regime.

Industry is making significant progress towards implementing the regime. We note that aspects of the framework for the regime, documented in the 'Principles of Reciprocity and Data Exchange' (PRDE) have been lodged by the industry body – the Australian Retail Credit Association (ARCA) – for approval by the ACCC. Should the ACCC process be successful, it is expected that industry can begin to exchange comprehensive data by the end of 2015.

6 Regulatory system

6.1 Overview

While Australia's regulatory system is generally sound, COBA agrees with the FSI's view that "there is scope to improve regulatory processes."[52] COBA is a strong advocate for reforms which improve regulator accountability and transparency, and we note that many of the recommendations put forward by the FSI are effective in this regard. In COBA's view, any recommendations which improve regulator accountability and transparency should be encouraged.

COBA also believes that some regulators, and APRA in particular, should place greater emphasis on competition and competitive neutrality in the implementation of their mandates. There are a number of ways that this could be achieved in practice, and we see the FSI's recommendation that Statements of Expectation be used to assist in delivering this outcome as a positive step.

6.2 Regulator Accountability

FSI Recommendation: Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates. Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance (recommendation 27)

This recommendation encompasses several different elements, with the overall objective of improving the regulator accountability framework. COBA strongly supports this objective, and also the proposal put forward by the FSI to achieve this outcome. However, there are several areas where we feel the detail of this recommendation could be modified slightly to achieve better outcomes.

The new Assessment Board

The Report recommends that the Assessment Board (FRAB) be tasked to provide the Government "…with ex-post, annual reports on the performance of APRA, ASIC and the payment systems regulation function of the RBA." These annual reports would "consider how the regulators have balanced the different components of their mandates…"[53] which would include competition.

The FSI Report acknowledges the overlaps between the proposed FRAB and existing Performance Framework processes, and recommends that FRAB, in addition to undertaking a broader review than that envisaged under the Performance Framework, also be responsible for validating the annual self-assessments.

Such an approach will improve the robustness of the Performance Framework, and help to avoid the risk of self-assessments lacking rigor. In this way, FRAB would build on the

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[52] Murray, *FSI Final Report*, November 2014, p. 235.
[53] ibid., p. 239.

existing Performance Framework, with the two systems being seen as complementary of each other rather than substitutes for each other. While the Government's introduction of the Performance Framework has been a welcome addition to the regulator accountability landscape, its existence in no way diminishes the case for the establishment of FRAB.

Statements of Expectation and Intent

This recommendation includes the suggestion that the Government make greater use of Statements of Expectation (SOEs) and Statements of Intent (SOIs) as a tool to improve regulator accountability.

SOEs were an outcome of the 2003 Uhrig Review, which recommended that Ministers issue SOEs which "outline relevant government policies, including the Government's current objectives relevant to the authority and any expectations the Government may have on how the authority should conduct its operations."[54] In response, regulatory agencies would issue SOIs "…outlining how it proposes to meet the expectations of government … including the identification of key performance…"[55]

The FSI report recommends that the current approach be strengthened through:

- The Government being "more explicit about trade-offs in regulatory policy (especially its risk appetite)…"; and
- Regulators devising performance indicators "that adequately capture the complexity of their work." [56]

The Government delivered an updated SOE to APRA in April 2014, and APRA responded with an updated SOI in July. COBA believes there is merit in updating APRA's SOI and SOE to take the FSI's recommendation into consideration. In particular, we believe significant scope remains to clarify expectations around trade-offs.

APRA's legislative mandate already requires it to balance a broad range of objectives, specifically financial safety, efficiency, competition, contestability, competitive neutrality and financial system stability.[57] However, the legislation does not explicitly state how these often competing objectives should be prioritised. The language used in the Government's SOE is that it would like to see APRA be an agency "…that balances the objectives of financial stability and efficiency, competition, contestability, and competitive neutrality…"[58] implying that all of these considerations should be given equal weight. In contrast, and despite this statement from the Government, APRA's view appears to be that the "…promote financial system stability…" aspect of the mandate sits above the other elements.

While COBA maintains that the best way to resolve any ambiguity around APRA's mandate would be to redraft section 8(2) of the APRA Act, failing this, a revised SOE is an alternative option that could be used to provide greater clarity.

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[54] Uhrig, *Review of the corporate governance of statutory authorities and office holders,* 2003, p. 7.
[55] ibid. p. 8.
[56] Murray, *FSI Final Report*, November 2014, p. 243.
[57] Australian Prudential Regulation Authority Act 1998, Section 8(2)
[58] Treasurer, *Statement of Expectations – APRA,* 2014, p. 4.

An explicit statement from the Government in a revised SOE which sets out the relative importance of the various aspects of APRA's mandate would be a positive development.

6.3 Strengthening the focus on competition

FSI Recommendation: Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate (recommendation 30)

Regular competition reviews

COBA strongly supports the FSI's recommendation for regular competition reviews. These reviews will ensure that a strong focus on competition in the banking sector is maintained going forward, and will make it more likely that emerging issues in the sector will be addressed in a timely fashion. The FSI Report correctly notes that without this change, "…there is a risk that regulators and policy makers will not place sufficient emphasis on competition when making decisions…"[59] Holding the reviews every three years is a sensible suggestion, which broadly aligns the reviews with the electoral cycle.

COBA recommends that these reviews be completed by a body with an appropriate degree of independence from the regulators, with organisations such as the Productivity Commission and the ACCC possible candidates. Stakeholders should have the opportunity to provide input into the review process, and share their insights and perspectives.

We also support the FSI's recommendation that, prior to the completion of the first review, "…regulators should examine their rules and procedures to assess whether those that create inappropriate barriers to competition can be modified or removed, or whether alternative and more pro-competitive approaches can be identified."[60] While recognising that several regulators are already reviewing their regulations as part of the Government's red tape reduction program, COBA believes that a more focused review which specifically considers the impact of the regulations on competition could deliver better outcomes.

Improved regulator reporting

The FSI Report notes that "…there is no current requirement for regulators to explain how they balance competition considerations with other regulatory objectives in reaching decisions."[61]

To address this shortcoming, the FSI has recommended that:

> "Through their annual reports, regulators should demonstrate that they have given explicit consideration to trade-offs between competition and other regulatory objectives when designing regulations. The effect of regulatory proposals on

[59] Murray, *FSI Final Report*, November 2014, p. 256.
[60] ibid., p. 254.
[61] ibid., p. 255.

> competition should be explained explicitly in consultation documents and annual reports…"[62]

COBA strongly supports this recommendation. While some regulators sometimes perform well in this area, these issues are generally considered in an ad-hoc fashion. There is significant value in formalising these processes to ensure that competition considerations are not overlooked and given due consideration. There may also be scope to integrate some of these obligations into the existing Regulation Impact Statement (RIS) process, which all regulatory proposals must already undergo.

ASIC's legislative mandate

COBA has previously noted that ASIC's legislative mandate does not currently include competition and we have called for this to be addressed.[63] We therefore welcome the FSI's recommendation that "Government should update ASIC's mandate to include a specific requirement to take competition issues into account as part of its core regulatory role."[64]

We do not see a risk of this overcomplicating or confusing ASIC's legislative mandate, and note that this amendment would simply allow them to consider policy matters in a more holistic fashion than they are currently able to. We also note that ASIC themselves have recommended that their legislative mandate be amended in this way.[65]

6.4 Compliance costs and policy processes

FSI Recommendation: Increase the time available for industry to implement complex regulatory change. Conduct post-implementation reviews of major regulatory changes more frequently (recommendation 31)

The FSI has called for improvements to be made to policy development processes, and in particular:

- Industry to be given a minimum of six months to implement a policy change once finalised, with additional transitional periods of 12-24 months "generally appropriate;"
- More post-implementation reviews should be carried out, with a greater focus on the cost effectiveness of the policy changes.

COBA has often noted that implementation timeframes for proposed changes are too tight, and that inadequate attention is given to whether the benefits of a proposed change outweigh the costs. COBA is therefore strongly supportive of these recommendations as a positive step towards improved policy implementation and review.

[62] Murray, *FSI Final Report*, November 2014, p. 254.
[63] COBA, *Submission to the FSI,* March 2014, pp. 56-57.
[64] Murray, *FSI Final Report*, November 2014, p. 254.
[65] See ASIC's FSI submission

6.5 Regulator funding models

FSI Recommendation: Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews (recommendation 28)

COBA supports the underlying principle of moving regulators to a more sound funding base by adopting a three-year funding model. In addition to providing regulators with greater certainty around their budgets, where regulators collect these fees from institutions it will also provide industry with greater certainty around their likely regulator levies. Excessive volatility regarding APRA levies is an issue that COBA has raised concerns about in the past, and to the extent that a longer term funding model could mitigate this risk, that would be a welcome development.

However, it is also important that any move to longer-term funding models be accompanied by an appropriate level of transparency, oversight, and stakeholder engagement, particularly for regulators where a proportion of costs are recovered through industry levies. It is critical that industry levies are only used where such an approach is supported by the government's cost recovery guidelines, and industry should be given an adequate opportunity to comment on both the aggregate size of the levy to be collected, and also how that levy is to be distributed among regulated entities. Transparency regarding both how a regulator calculates its total budget, and how it intends to distribute costs among regulated entities, is essential for industry to have confidence that the approach being adopted by the regulator is appropriate.

7 COBA position on FSI recommendations

COBA's position on each of the FSI recommendations addressed in this submission is set out below:

Resilience Recommendations

Recommendation 1	Supported, with higher D-SIB capital surcharge used as an interim measure
Recommendation 2	Supported
Recommendation 3	Supported
Recommendation 4	Supported
Recommendation 5	Supported in principle
Recommendation 6	Supported
Recommendation 7	Supported

Innovation Recommendations

Recommendation 20	Voluntary CCR regime supported

Consumer Outcomes Recommendations

Recommendation 21	Supported in principle
Recommendation 23	Supported
Recommendation 25	Supported in principle

Regulatory System Recommendations

Recommendation 27	Supported
Recommendation 28	Supported in principle
Recommendation 30	Supported
Recommendation 31	Supported

Appendix 1 Recommendations

Recommendation 35	Supported
Recommendation 40	Supported in principle

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