RESPONSE TO THE INTERIM REPORT OF THE FINANCIAL SYSTEM INQUIRY

ANZ
26 AUGUST 2014

EXECUTIVE SUMMARY

The Australian banking sector is competitive, concentrated, stable and resilient. Customer satisfaction is high and consumers have access to an extensive range of products and providers.

Although tested during the global financial crisis (GFC), Australia's financial system performed well relative to its international counterparts. Australian taxpayers did not bail out an Australian Authorised Deposit-taking Institutions (ADI) and other measures, such as the wholesale funding guarantee, generated revenue for taxpayers. In response to the GFC, Australian banks and regulators have taken material steps to increase the resilience of the financial system.

A central focus of the Inquiry is *minimising risks to taxpayers* arising from any future shock. ANZ considers that the Australian banking system has robust features that limit instability in the event of an external shock and strong capacity to respond to a crisis. The interim report notes that it is hard to eliminate completely perceptions that some institutions are too-big-to-fail (TBTF). Internationally these pressures have been felt most acutely where governments bailed out failing financial institutions with taxpayers' money.

The significant strengthening of the system since the GFC, along with the wide range of other structural protections inherent in Australia's financial system, obviate the need for additional loss absorbency. It is estimated on a consistent basis that Australian bank common equity capital ratios are at the 75th highest percentile compared to global peers. Regulatory strengthening that has been implemented or is planned, including the APRA Domestic Systemically Important Bank (D-SIB) additional capital charge, will protect a capital level of 5.125 per cent against an extreme, one in 5000 year event. Further increasing capital requirements or loss absorbency will come at a material cost and would deliver limited additional benefit.

The interim report does not contain a compelling case that further strengthening would provide additional benefits to the financial system. TBTF arguments, dealing with perceptions, do not first demonstrate that there is a need to take additional measures to ensure that the taxpayer is not 'on the hook'.

Many efficient, low cost measures can be taken to improve system resilience, productivity and economic growth. APRA could work more actively with ADIs using standardised risk weighting to obtain Internal Rating Based accreditation. Gaps in regulator resolution powers can be closed and transparent internationally harmonised information on capital ratios should continue to be progressed.

The interim report discusses two main ways system loss absorbency could be increased: higher capital levels or by 'bail-in' of debt instruments.

Increasing loss absorbency via bail-in of senior unsecured debt or greater subordinated debt would result in fewer costs to the financial system and provide greater additional buffers than further increases in Common Equity Tier 1 (CET1) (via a higher D-SIB Capital Conservation Buffer).

Arguably, bail-in imposes more market discipline on banks given that market-based risk spreads are readily available. Higher capital ratios perversely could lead to greater risk appetite or encourage 'shadow banking' activity.

The implications of bail-in are, however, material for the system. First, as is currently being considered in other jurisdictions, bail-in of senior unsecured debt will likely result in a review of the Australian banks' credit ratings by the rating agencies. This will increase the cost of funding for the system (up to AUD1 billion per annum) and likely restrict

funding availability (for example, where funding providers have mandate restrictions based on the credit rating of the issuer).

ANZ supports assisting ADIs that are not internal ratings-based (IRB) accredited in attaining this accreditation including removing any impediments, subject to maintaining the integrity and credibility of the process. This may include a staged process of accreditation, prioritising mortgage portfolios rather than requiring whole-of-bank accreditation.

ANZ cautions against a scaled-back approach to accreditation standards. This may have the unintended consequence of reducing capital held against risks that are not properly understood or managed. The objective should be to ensure that the prudential framework facilitates the creation of a level playing field for risk management. It should not be to force equalisation of the capital requirements without regard to the risk profile, risk management and risk infrastructure.

Indeed current market pricing for residential mortgage-backed securities (RMBS) does not support the view that the mortgage risk of the smaller banks is equivalent to that of the major banks.

In other areas, there are many opportunities for improving the performance of the financial system. The efficiency of the *superannuation* market will be improved by the implementation of the Strong Super reforms and government policy to increase default fund competition. A consistent and transparent approach to fee and expense disclosure across the industry would assist consumers to make informed decisions. More work is needed on general underinsurance issues and targeted reforms to improve life insurance outcomes for consumers.

The provision of *financial advice* can be improved by better accreditation, training and continuing education, and by an enhanced public register of advisors. Retirement outcomes policies need to be reviewed to ensure the market provides appropriate products and clear information to address the needs of retiring Australians. Improved community financial literacy will also help consumers make informed choices.

Better *disclosure for consumers* can be achieved by strategies such as 'layered' disclosure, simplification and prioritisation of electronic delivery. Cyber security should be identified as a priority area. Technology neutrality is an important principle.

Overall *policy objectives for the financial system* should be to achieve the best economic welfare outcomes, and a stable and reliable system that is accessible and fair. Decision-making should explicitly take into account the international competitiveness of Australian business and the interests of consumers. Government should be encouraged to articulate the risk associated with investment in different asset classes. Promoting *international integration*, consistent with stability objectives, is important for growth and an existing body should be given specific accountability for this function.

SUMMARY OF ANZ VIEWS

Stability and resilience

1. The Australian banking system has strong features that limit instability in the event of an external shock and provide a deep capacity to respond to a crisis. A compelling case for material additional loss absorbency beyond those now being implemented has not been made. Further measures would come at a material cost and would deliver limited additional benefit.

2. The interim report notes that it is hard to eliminate completely perceptions that some institutions are TBTF. Internationally these pressures have been felt most acutely where governments bailed out failing financial institutions with taxpayers' money.

3. The report discusses several ways greater loss absorbency could be increased: additional CET1 or a bail-in mechanism for certain classes of creditors (i.e. subordinated and senior debt). Bail-in of senior unsecured debt or additional subordinated debt would likely result in fewer costs to the financial system than further increases in CET 1. Bail-in would have material implications such as a likely review of credit ratings, and impacts on funding costs (up to AUD1 billion per annum) and credit availability. Bail-in may decrease stability during a stress event although risks could in part be mitigated.

Competition

4. The integrity of the IRB as a fact-based and comprehensive system of risk management should be protected. It is appropriate that APRA provide support to institutions to move to an IRB system, including prioritising accreditation for mortgage portfolios. ANZ cautions against a scaled-back approach to accreditation standards. This may have the unintended consequence of reducing capital held against risks that are not properly understood or managed. The objective should be to ensure that the prudential framework facilitates the creation of a level playing field for risk management. It should not be to force equalisation of the capital requirements without regard to the risk profile, risk management and risk infrastructure. (Refer also Attachment 2-16)

Funding

5. ANZ adopts a prudent approach to mortgage lending and closely manages risks posed by housing under the close supervision of regulators. Banks have extensive risk management capabilities and models in place to minimise risk and this asset class receives significant management and Board focus. ANZ notes that assets other than residential mortgages are most likely to be affected by an economic downturn.

6. ANZ has ample funds available for lending to small business and is providing ready access to finance to creditworthy customers. ANZ has invested significantly to improve lending to small business and better manage credit. The rollout of CCR, and other initiatives in train will improve availability of credit information and data on lending to small business. (Refer also Attachment 2-18, 2-68)

7. Higher levels of household superannuation savings may affect bank lending depending on banks' management choices and market developments. Increasing the proportion of bank funding sourced through superannuation funds from households' savings, rather than through retail deposits, would affect banks' ability to fund term lending. Term lending may be reduced due to the lower levels of 'stickiness' displayed by wholesale funding relative to retail deposits, depending on the contractual tenor of the particular investment.

Superannuation

8. The Stronger Super reforms and government policy on default superannuation funds selection are designed to promote competition and reduce costs. The completion of this major program of reform will provide competition, disclosure and other benefits to consumers. A consistent and transparent approach to fee and expense disclosure across the industry would assist consumers to make informed decisions. An appropriate rationalisation regime for superannuation investment structures, products, and funds would also assist the industry in improving scale and efficiencies. (Refer also Attachment 2-114 to 2-126)

Stability

9. ANZ supports certain measures to improve regulators' resolution powers and a greater focus on resolution planning and pre-positioning. This needs to be undertaken in a targeted and cost effective manner. A number of difficult issues remain, such as appointment of a statutory manager to a solvent non-operating company or subsidiary, and suspension of continuous disclosure obligations.

10. Australian banks do not have the complex business models that ring-fencing of investment banking and proprietary trade activities is designed to address. APRA should continue to monitor banks to identify relevant risks or exposures.

11. APRA and the RBA have wide existing powers related to macroprudential management and the value of further macroprudential tools is unclear. Institutions or activities that pose risks to the financial system should be able to be brought within the prudential perimeter. Stress testing is an important tool for assessing risks and setting risk appetite. (Refer also Attachment 3-31)

12. Australian bank capital ratios are conservative. Prudential settings should be determined taking into account the structure, performance and risk associated with Australian banks. ANZ strongly supports measures to increase the transparency and comparability of bank capital ratios across jurisdictions.

13. Clarification is required to ensure that there is a proper distinction between Board and Management responsibilities within financial institutions. (Refer also Attachment 3-44)

Consumer outcomes and conduct regulation

14. Strategies are needed to improve disclosure, including 'layered' disclosure, simplification and prioritisation of electronic delivery. ANZ will make a separate submission on retail product disclosure to the Inquiry.

15. Consumer confidence in affordable, quality financial advice is important for the proper functioning of the retail investment market. The provision of financial advice can be improved by better accreditation, training and continuing education, an enhanced public register of advisors, and reviewing regulation to allow appropriate digital provision of advice. Raising consumer understanding of risks and returns associated with investment products should be a continuing focus for regulators and industry. (Refer also Attachment 3-72 to 3-74)

16. The effectiveness of the life insurance market, coverage and affordability can be significantly improved with targeted changes, and a cooperative approach between the industry, regulatory bodies and key groups such as superannuation funds. ANZ supports continued work on financial literacy, including underinsurance, led by ASIC, coordinating across government, and in partnership with not for profit groups and industry. (Refer also Attachment 3-82 to 3-87)

Regulatory architecture

17. ANZ emphasises that the Government and regulators should conduct transparent cost benefit analysis of major regulatory changes, and ensure appropriate accountability measures at different stages of the regulatory process. Consistent with the Inquiry's principles of transparency and accountability, as well as government policy, long-form regulatory impact statements should be recommended for significant new rules, or changes to rules, affecting the financial system. Guidelines should be established indicating the expected thoroughness of evaluations, including quantitative

assessment. These requirements should be related to the potential impact on financial assets and flows.

18. Market efficiencies would arise from improved accountability mechanisms established before regulation is implemented, during the operation of regulation and to evaluate outcomes. Targets for removing obsolete regulation are important and should be maintained.

19. Regulators should be given a clear mandate that their role is not only to ensure a stable and well-functioning financial system, but also to facilitate economic growth. The framework articulated in the interim report is strong but could be refined by more closely defining overall objectives for the financial system and each regulator, the approach to achieving these objectives, matters that should be taken into account in regulatory decision-making and risk associated with investment in different asset classes. (Refer also Attachment 3-121 to 3-129)

Retirement incomes

20. Retirement income policies need to be reviewed to ensure the market provides appropriate products and clear information to address the needs of retiring Australians. Rules for superannuation, taxation and social security support have complex interactions that should be examined in order to maximise benefits for retirees and to reduce the burden to the greatest extent possible on taxpayers. (Refer also Attachment 4-8 to 4-31)

Technology

21. Cyber security is a priority for the industry as financial services shift to mobile and online channels. The Cyber Security Strategy should be reviewed and industry-regulator collaboration on security matters encouraged. A national strategy on digital identities is important. Technology neutrality is an important principle and there are opportunities for removing obstacles to digital services. The new privacy regime should be allowed to bed down. Issues about cross border transmission of information should be reviewed. (Refer also Attachment 4-41 to 4-71)

International integration

22. Economic and productivity growth will be maximised if Australian businesses are internationally competitive and able to adapt to change. Regulation of the financial system should assess and take into account the impacts of regulatory settings on costs to Australian businesses when making decisions.

23. Promoting international integration, consistent with stability objectives, is important for economic growth and an existing body should be given specific accountability for this function. (Refer also Attachment 4-81 to 4-102)

ANZ RESPONSE TO THE FINANCIAL SYSTEM INQUIRY INTERIM REPORT

ANZ welcomes the opportunity to provide comments on the Financial System Inquiry ('the Inquiry') Interim Report ('interim report').

Sections one and two of this response provide an overall view of the interim report and key stability issues, followed by responses to major points in the interim report. The Attachment provides detailed comments on remaining interim report observations, policy options and requests for additional information.

1. INTRODUCTORY COMMENTS

The Inquiry identified three principles to be satisfied by the financial system in order to meet Australia's evolving needs and effectively support Australia's economic growth.

These are that the financial system must efficiently allocate resources and risks, be stable and reliable, and be fair and accessible.[1] ANZ agrees with these principles and supports their use as a basis for assessing the performance of the financial system and identifying areas where improvements can be made.

The interim report makes many observations about the current performance of the financial system. ANZ supports the Inquiry's view that:

- Although tested during the global financial crisis (GFC), Australia's financial system performed well in most respects relative to its international counterparts. In response to the GFC, Australian regulators and the government have taken steps to increase the resilience of the financial system.[2]
- The stability of the Australian financial system is the result of a number of factors, including a stable macroeconomic environment, prudent risk management by financial institutions, and a traditional, comparatively low-risk and profitable commercial banking model.[3]
- The Australian banking sector is competitive, albeit concentrated. Returns on equity are around those of large Australian companies, and customer satisfaction is now at record highs.[4]
- The financial system is based on market principles that support risk taking and allow both success and failure. A well-functioning financial system is underpinned by predictable rule of law with strong property rights, a freely convertible floating currency, sustainable fiscal policy, a sound monetary policy framework and a stable political system.[5]
- Financial system regulators need sufficient powers, independence and resourcing; but they should also be subject to rigorous accountability mechanisms. Regulation should be cost-effective, transparent, targeted, forward-looking, and competitively and technologically neutral.

[1] Interim report, 1-1.
[2] Interim report, 1-18.
[3] Ibid.
[4] Interim report, 2-3, 2-6.
[5] Interim report, 1-1.

- The Government should minimise the expectation of taxpayer funds being used to support the financial system, specific institutions or sectors.[6] As noted in the interim report, Government may need to intervene during a financial crisis to avoid disorderly failures, and a strong Government balance sheet is important for this purpose.
- Competition should be the cornerstone of a well-functioning financial system, driving efficient outcomes for price, quality and innovation. Wherever possible, the financial system should be subject and responsive to market forces.[7]
- Australian regulation should adopt key aspects of internationally driven regulation, while adapting it to meet key aspects of national conditions.[8]
- Superannuation settings lack stability, which adds to cost and reduces long-term confidence and trust in the system.[9]
- The current retail product disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs.[10]
- Affordable, quality financial advice can bring significant benefits for consumers. Improving adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower-cost scaled advice.[11]
- The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees. There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.[12]

2. STABILITY AND RESILIENCE

On the core question of the stability of the financial system, ANZ has concerns that the interim report moves too readily from recognising the strong underpinnings and performance of the Australian financial system, through and since the GFC, to considering how the system might now be further bolstered.

ANZ's view is that the interim report does not establish a compelling case for several key additional policy options raised, specifically the need for more system loss absorbency. For other measures, aimed at improving system resilience rather than loss absorbency (e.g. stress testing, resolution regimes), the case is more that of extending current policies to be more effective in the post GFC environment.

Strength of the financial system

The interim report rightly chronicles the relative strength of Australia's banking system during the GFC. It notes that the government intervened in the form of wholesale and deposit guarantees, and provided support for the securitisation market. Nevertheless, there was no call on taxpayers and, given the effective response by banks, government and the regulators, there were few significant issues from these externally driven systemic pressures.

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[6] Interim report, 3-3. See also comments on minimising exposure of taxpayers in other areas such as mortgage lending and residential mortgage-backed securities (RMBS) (2-15), or small business (2-67).
[7] Interim report, 2-3.
[8] Interim report, 1-5.
[9] Interim report, 1-9.
[10] Interim report, 1-10.
[11] Ibid
[12] Ibid

Banks and the regulators took steps during the GFC and since then to strengthen the stability and resilience of the financial system. These measures include:

- Banks have implemented Basel III capital rules, increased capital and strengthened their funding (including by reducing the reliance on short-term, offshore debt).
- Banks have implemented Basel III compliant Tier 1 and Tier 2 instruments including with Point of Non-Viability (PONV) equity conversion.
- APRA has imposed a one per cent Common Equity Tier 1 (CET1) Domestic Systemically Important Bank (D-SIB) capital charge on major banks, effective from 1 January 2016.
- Liquidity positions have been strengthened. The Liquidity Coverage Ratio (LCR) with the Committed Liquidity Facility (CLF) will be implemented from 1 January 2015. The strong capital position of the system makes it easier for the RBA to provide liquidity support as needed.
- The Financial Claims Scheme (FCS) has been implemented, providing protection to depositors (up to AUD250,000 per account-holder per ADI) and timely access to deposits in the unlikely event of the failure of an ADI.
- Greater focus has been placed on stress testing and resolution regimes.

The results of the International Monetary Fund (IMF) and the Australian Prudential Regulation Authority (APRA) system stress tests, prior to the full implementation of the measures above, show that the banking system is robust. The IMF test reported in 2012 confirmed the Australian system remained above capital minimums (Tier 1) under a severe stress event.[13] This was also the outcome from the 2011 APRA stress tests for Common Equity Tier 1 (CET1).

The interim report notes that "during the GFC significant government actions in a number of countries, including Australia, entrenched perceptions that some institutions are too-big–to- fail (TBTF)".[14] It states that "these perceptions can be reduced in Australia by making it more credible to resolve these institutions without Government support".

ANZ acknowledges that in other countries significant taxpayer support was provided to banks at considerable cost to the economy and taxpayers. This has no doubt underpinned TBTF perceptions and international steps to reduce risks to taxpayers.

In Australia, however, the benefits of the limited range of initiatives used to support the system during the GFC were generally shared by all institutions, not just the large banks. The Government guarantee on deposits should not be viewed as an emergency GFC measure; it is a long-standing function of almost all countries' banking systems which Australia did not adopt until 2008. The Government guarantee on deposits arguably supported the smaller domestic banks' liquidity management more than it supported major banks.

The wholesale debt and large deposit guarantees were used by many banks, either domestically or offshore, with no cost to taxpayers (in fact, these represented a significant revenue stream for the Government). The support for the residential mortgage-backed security (RMBS) market by the Australian Office of Financial Management used taxpayer funds and was exclusively for non-major banks.

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[13] IMF, *Australia Financial System Stability Assessment*, IMF Country Report 12/308, November 2012. Refer pages 39 to 42. The severe recession scenario included a GDP trough of -5 per cent GDP, 12 per cent peak unemployment rate, 47 per cent decline in equity prices, 35 per cent decline in house prices and 40 per cent decline in commercial property prices. This analysis suggests that further major changes to the existing regulatory framework would be likely to result in limited improvement in stability.

[14] Interim report, p. xxvi.

TABLE 1: AUSTRALIAN FINANCIAL STABILITY LANDSCAPE

Preventive features			Protective actions		
Structural protection	**Regulatory and supervisory regime**	**Banking system protections**	**Individual firm actions**	**Systemic actions**	**Living will / resolution regimes**
Current system					
• Sound macro position • Floating AUD • Variable interest rates • Stable retail investor base • 'Traditional' retail/commercial banking • Mortgage security/legal framework • Most of system captured by regulatory regime • Four pillars	• Clear independent supervisory roles • APRA adopts conservative stance and is an active supervisor • Concentrated system (small number of banks) assists supervision • Depositor preference and FCS • Covered bonds • CLF • Basel III changes already implemented (i.e. capital)	• 'Traditional' banking models • Mortgage lending conservatively structured • Strong capital positions with D-SIB recently added • Conservative funding structures • Risk appetite more considered and closely supervised • Balance sheet, business mix and geographic diversification	• Proven ability to raise capital in stress • DRP adds flexibility • Manage impact of cost of funding – supports profitability and lending • Plans to manage stress situations • Unused covered bond capacity • PONV regulatory capital instruments	• Precursor to CLF worked in GFC • RBA monetary policy effective in managing household and business cash flow pressures • Fiscal actions	• Clear Board and APRA approved action plans to manage individual firm issues in short timeframes • Proven history of managing transition of failing financial institutions
Possible additional measures noted in the interim report					
• Macro prudential tools	• FCS changes • Greater stress testing • Ring fencing • Internationally consistent approach to capital • Invest more in pre-planning and pre-positioning for financial failure	• Increase in CET1 • APRA/Banks publish capital comparisons	• Bail-in to add significantly to loss absorbency in an individual firm crisis (sub-debt and senior)	• Bail-in • Term repo with RBA • Add to covered bond capacity in stress events	• Strengthen regulators resolution powers

Abbreviations: CET-1 - Common Equity Tier 1, CLF – Committed Liquidity Facility, DRP – dividend reinvestment plan, D-SIB – Domestic Systemically Important Bank, FCS – Financial Claims Scheme, PONV – Point of non-viability, RMBS – residential mortgage-backed security

TBTF arguments, dealing with perceptions, are presented as reasons to consider a range of measures that could be used to strengthen the loss absorbency of the current system. The arguments fail to first demonstrate that there is a need to take additional measures to ensure that the taxpayer is not 'on the hook'.

ANZ believes that the recent strengthening of the system noted above, along with the wide range of other structural protections inherent in Australia's financial system (see Table 1) obviate the need for significant additional loss absorbency. In our view, the interim report does not contain a compelling case that further strengthening would provide additional benefits to the financial system.

As set out in Table 1, the Australian financial stability landscape also has features that minimise instability in the event of an external shock with the capacity to respond strongly to a crisis.

The preventive features include 'automatic stabilisers' such as the floating exchange rate and variable interest rates, a traditional banking model, and a strong regulatory and supervisory regime of independent agencies.

Banks have demonstrated their ability to take actions that support their individual institution. They have the ability to raise capital directly and through dividend reinvestment plans. Banks have put in place APRA and Board-approved plans to manage individual institution recovery within a short time-frame.

The relatively small number of participants and traditional nature of the Australian banking system also allows action to be taken quickly by regulators to deal with failure. The government and RBA have fiscal strength and monetary flexibility to reduce pressures on the economy.

Capital and risk reduction trade-off

In order to quantify the resilience of the system, and to assess the trade-off between more capital and reduced system risk, an assessment of the probability of loss for a given level of capital has been modelled (Chart 1).

ANZ modelled its March 2014 data using the Basel regulatory capital distribution formula. The analysis demonstrates that current capital levels, which are lower than those that will apply from 1 January 2016 with the introduction of the D-SIB requirements, generate very low loss probabilities against a capital level of 5.125 per cent. This capital level could be seen as the trigger point of non-viability and where additional Tier 1 securities convert to equity.

Chart 1 shows that CET1 of 8.3 per cent creates a sufficient buffer above the 5.125 per cent level to withstand a 1:100 year event. When equity conversion features of new Tier 1 and Tier 2 instruments are added (after the transition to full Basel III compliant securities), modelled resiliency increases to the equivalent of a 1:5000 year event. As capital levels increase towards 9 per cent under APRA's D-SIB framework, resiliency will increase further.

While it may be convenient to dismiss this as mere modelling and assume financial sector risks may not behave in a 'normal distribution', this analysis nonetheless demonstrates the limited benefit achieved through further increases in loss absorbency. It also reinforces the findings of the regulator stress tests and points to the current strength of Australia's position.

CHART 1. DIMINISHING BENEFITS OF ADDITIONAL CAPITAL (GONE CONCERN LOSS ABSORBING CAPITAL)
Current capitalisation levels are adequate in protecting a 5.125% capital level in a ~1 in 5,000 year event
(Based on Basel regulatory capital distribution formula)

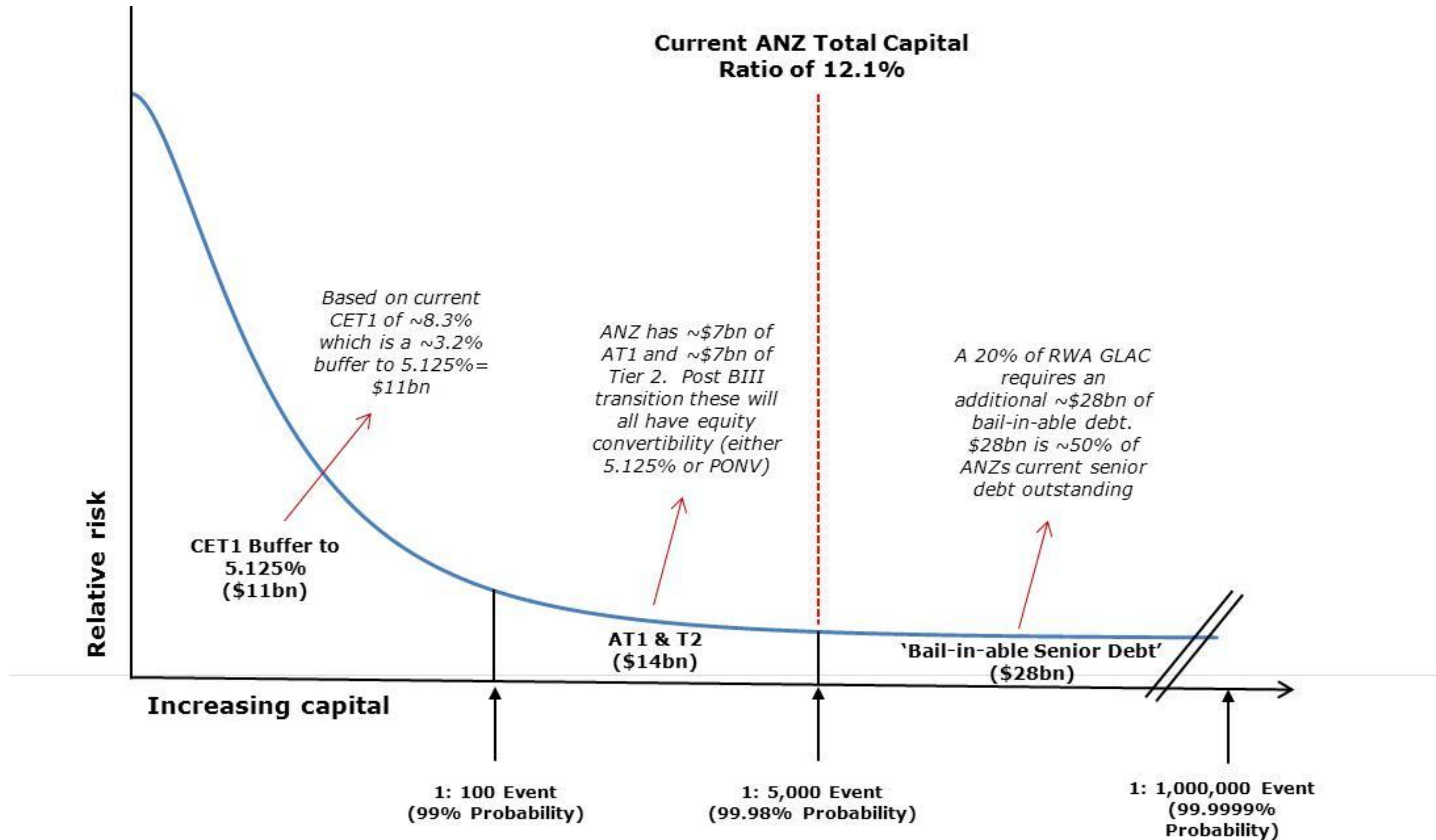


CHART 2. ANZ HAS SIGNIFICANTLY INCREASED LOSS ABSORBENCY SINCE 2007, CONSISTENT WITH THE MATERIAL STRENGTHENING OF REGULATORY REQUIREMENTS ALREADY IMPLEMENTED

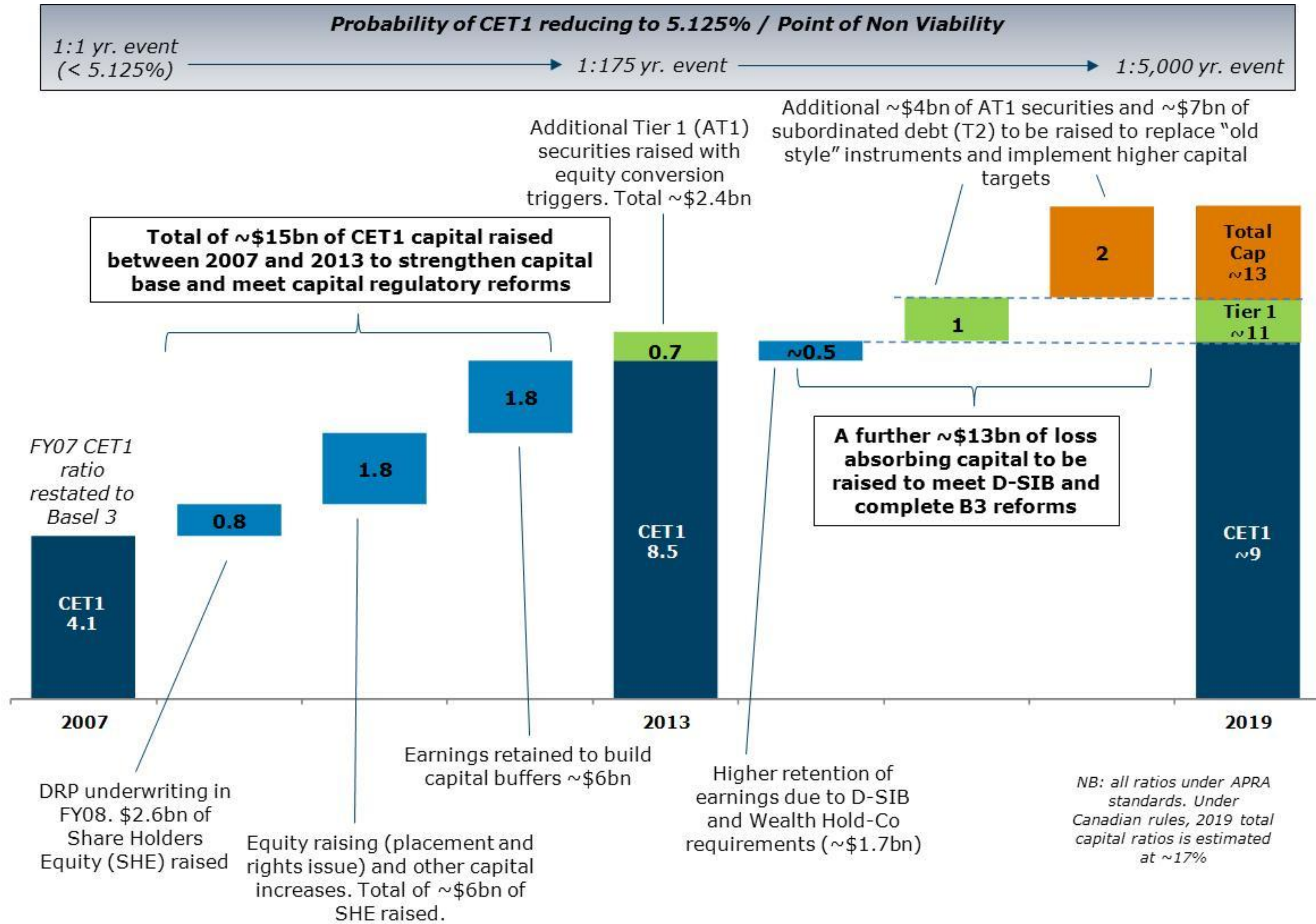
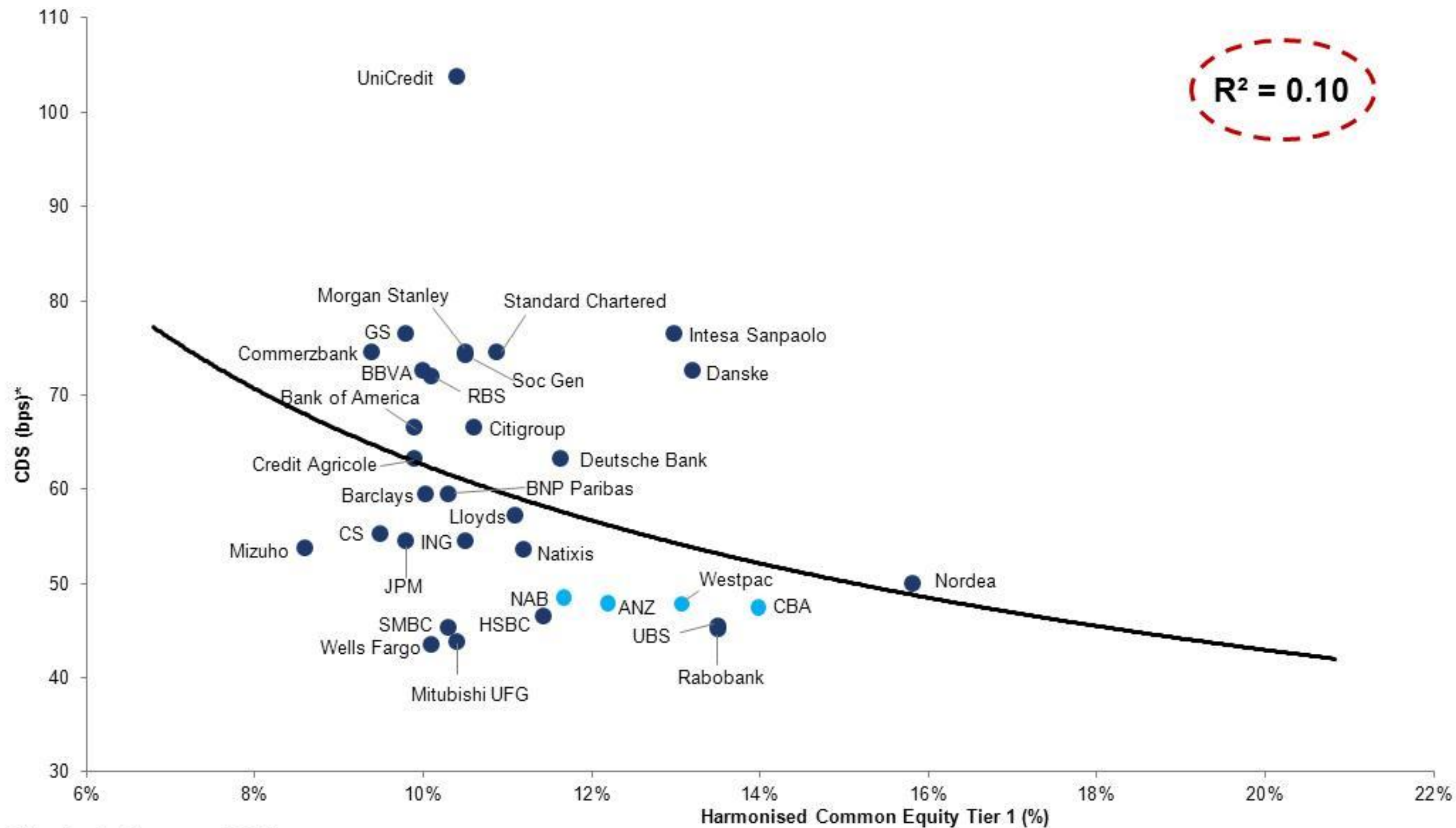


CHART 3. CREDIT DEFAULT SWAP (CDS) PRICES AGAINST BANK CORE CAPITAL
Credit default swap prices for Australia are low relative to peers, indicating that the market attributes benefits to the structural and regulatory frameworks in which Australian banks operate, in addition to the banks' capital position



*5yr Senior Unsecured CDS
Source: Bloomberg, PWC

Chart 2 shows a time-series version of the probability analysis in Chart 1 and demonstrates the significant increase in ANZ's capital position following the GFC. The Chart shows that on a comparable (Basel III) basis, the CET-1 ratio has more than doubled, while new style loss absorbing securities are progressively replacing less loss absorbing instruments. As demonstrated in Chart 1, the material strengthening in the banks' balance sheet has greatly reduced the probability of a loss that would take the bank to the PONV.

Similarly, a review of Credit Default Swap spreads and CET1 positions of banks across many jurisdictions suggests that markets do attribute benefits to the structural and regulatory frameworks in which Australian banks operate in addition to their capital position (Chart 3).

The interim report notes that many of the measures which could "reduce the costs associated with too-big-to-fail … also have an effect on competition".[15] ANZ agrees some of the measures discussed affect both TBTF and competition. However, we believe that competition issues are best addressed directly rather than as a by-product of stability measures.

For example, smaller banks have argued that advanced internal ratings-based (IRB) model banks have a capital and, therefore, a competitive advantage in mortgages. Any competitive playing field issue is best managed by looking at ways the smaller banks can better quantify and model risks, and thereby reduce their capital weights rather than requiring greater capital imposts on the major banks. Such outcomes are better for the economy and the efficiency of the system.

Improving system resilience

The Interim report suggests a number of measures that could improve system resilience.

ANZ supports the enhancement and use of preventive measures such as greater use of stress testing and more pre-planning and pre-positioning for financial failure. We also believe stronger protective measures in the event of stress could be considered. For example, regulators could consider increasing the current maximum limit on covered bonds issuance from 8 per cent of Australian assets and extending the current RBA repo arrangements to include term repos to assist banks in managing the tenor of their funding in periods of stress.

System loss absorbency

The interim report notes that it is hard to eliminate completely perceptions that some institutions are TBTF. Internationally these pressures have been felt most acutely where governments bailed out failing financial institutions with taxpayers' money.

The Inquiry report suggests three broad reasons why Australia might need to consider its level of system loss absorbency:

- First, in order to combat TBTF perceptions and possible taxpayer liabilities, system loss absorbency should be increased. ANZ disagrees given the high levels of system resilience following the measures taken both during and after the GFC (refer page 5, and Chart 1 and Chart 2).

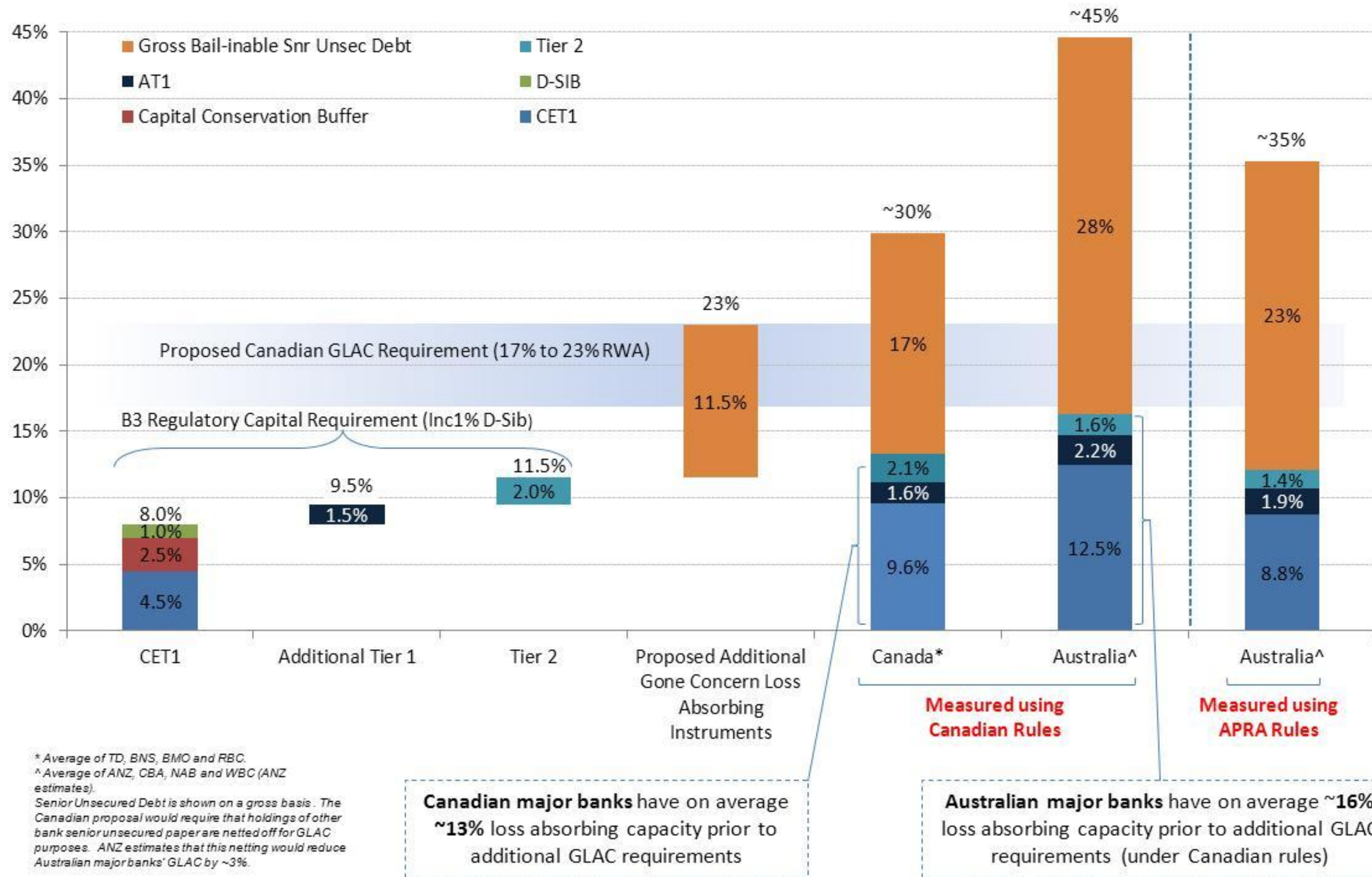
- Second, Australia's involvement in supervisory fora such as the Basel Committee on Banking Supervision and the Financial Stability Board (FSB) requires us to participate in internationally agreed approaches to maintain and improve financial stability.

[15] Interim report, 3-10.

CHART 4. CANADIAN GLAC PROPOSAL WITH AUSTRALIAN MAJOR BANK POSITION

Australian banks very well positioned under this approach to GLAC – well in excess of the potential minimum ratios

(August 2014)



Globally, the FSB and other supervisory bodies have been discussing the need for increased levels of loss absorbency. Specifically, they have been considering what might be an appropriate level of Gone-concern loss absorbing capacity or 'GLAC' (i.e. bail-in initiatives) and have contemplated a range from the high teens to a maximum of 30 per cent of Risk Weighted Assets (RWA).

ANZ understands the argument that Australia should conform to international financial regulations, but these regulations should and do allow for national discretion and, given our current strong position, Australia should not lead any implementation of higher GLAC. The higher levels of loss absorbency currently being contemplated internationally would come at a material cost but with diminishing stability benefits. That is, there would be limited further reductions in the probability of breaching the point of non-viability associated with these measures (refer Chart 1).

- Third, the report argues that because Australia is and will remain a significant borrower in international markets, there is a case for Australian capital ratios being stronger than the average of G20 countries – the interim report referred to Australia's banks as being in the "middle of the pack". Analysis shows Australia's major banks are already at the 75th percentile of capital levels, which supports ANZ's view that no additional GLAC measures need to be implemented to support banks' access to markets.[16]

GLAC measures discussed in the interim report

The interim report discusses two main measures to increase system GLAC: additional CET1 or a bail-in mechanism for certain classes of creditors (i.e. subordinated and senior debt).

Any review of these measures should consider both efficiency and stability impacts.

Increasing loss absorbency via bail-in of senior unsecured debt or greater subordinated debt would likely result in fewer costs to the financial system than further increases in CET1 (via a higher D-SIB Capital Conservation Buffer).

Bail-in results in an additional contingent cost to achieve greater loss absorbency compared to the immediate and materially higher cost of additional common equity. Furthermore, the size of the Australian system's senior unsecured debt (~AUD60 billion in the case of ANZ) suggests materially more loss absorbency will be achieved with this approach relative to an additional D-SIB requirement (only ~AUD7 billion for a two percentage point D-SIB increase).

Arguably, bail-in imposes more market discipline on banks given that market-based risk spreads are readily available. Higher capital ratios perversely could lead to greater risk appetite or encourage 'shadow banking' activity.

Taking the current Canadian consultation paper on GLAC and bail-in as an example, under the Canadian proposals and capital ratio methodology, Australia's system would have a GLAC ratio of ~45 per cent of RWA (see Chart 4).

The implications of bail-in are, however, material for the system. First, as is currently being considered in other jurisdictions, bail-in of senior unsecured debt will likely result in a review of the Australian banks' credit ratings by the rating agencies. This will increase the cost of funding for the system (up to AUD1 billion per annum) and likely restrict funding availability (for example, where funding providers have mandate restrictions based on the credit rating of the issuer).

[16] PwC, *Australian Bankers' Association: International comparability of capital ratios of Australia's major banks*, August 2014.

Second, senior debt bail-in may decrease system stability during any future global or domestic stress event. A severe stress event will result in markets' expectations of the probability of bail-in increasing, thereby escalating the speed and severity of funding market dislocations and closures. This second risk could partly be mitigated. Possible mitigation steps might include a central bank term repo facility (i.e. similar to the European Central Bank's long-term refinancing operation – ECB LTRO); increasing the existing cap on covered bond capacity (currently set at 8 per cent of Australian assets); or including a Canadian style '400 day rule' (i.e. excluding one or two year debt) such that shorter dated issuance is not subject to bail-in.

ANZ view

1. *The Australian banking system has strong features that limit instability in the event of an external shock and provide a deep capacity to respond to a crisis. A compelling case for material additional loss absorbency beyond those now being implemented has not been made. Further measures would come at a material cost and would deliver limited additional benefit.*

2. *The interim report notes that it is hard to eliminate completely perceptions that some institutions are TBTF. Internationally these pressures have been felt most acutely where governments bailed out failing financial institutions with taxpayers' money.*

3. *The report discusses several ways greater loss absorbency could be increased: additional CET1 or a bail-in mechanism for certain classes of creditors (i.e. subordinated and senior debt). Bail-in of senior unsecured debt or additional subordinated debt would likely result in fewer costs to the financial system than further increases in CET 1. Bail-in would have material implications such as a likely review of credit ratings, and impacts on funding costs (up to AUD1 billion per annum) and credit availability. Bail-in may decrease stability during a stress event although risks could in part be mitigated.*

The following sections of this response summarises comments on each chapter of the interim report, following the order set out in the interim report. As noted, the Attachment provides the detailed ANZ response to other observations, policy options and requests for further information contained in the interim report.

3. COMPETITION

Regulatory capital requirements

The preliminary assessment of the inquiry is that the "application of capital requirements is not competitively neutral. Banks that use IRB risk weights have lower risk weights for mortgage lending than smaller authorised deposit-taking institutions (ADIs) that use standardised risk weights, giving the IRB banks a cost advantage".[17] A number of options are suggested including 'no change', assisting non-IRB banks to obtain accreditation, increasing IRB risk weights, changing standardised weights and allowing IRB for some product groups only.

The interim report also notes that major banks have lower wholesale funding costs than their smaller competitors, in significant part because of the major banks' size, their greater access to capital, the diversity of their lending portfolios and their sophisticated risk management systems.[18] Customers benefit from the efficiencies provided by larger banks and it would be inappropriate for prudential regulation to be changed to offset efficiency differences or promote competition.

ANZ supports assisting ADIs that are not IRB accredited in attaining this accreditation including removing any impediments, subject to maintaining the integrity and credibility of the process. This may include a staged process of accreditation, prioritising mortgage portfolios rather than requiring whole-of-bank accreditation.

ANZ cautions against a scaled-back approach to accreditation standards. This may have the unintended consequence of reducing capital held against risks that are not properly understood or managed. The objective should be to ensure that the prudential framework facilitates the creation of a level playing field for risk management. It should not be to force equalisation of the capital requirements without regard to the risk profile, risk management and risk infrastructure.

Indeed current market pricing for RMBS does not support the view that the mortgage risk of the smaller banks is equivalent to that of the major banks.

ANZ does not support increasing the minimum IRB risk weights. ANZ notes that the current 20 per cent loss given default (LGD) floor already represents a materially higher capital requirement than unadjusted modelled outcomes. Further arbitrary increases in the IRB floor would result in a greater departure from one of the core IRB principles, that the capital requirement reflects the actual risk profile of the portfolio. An alternative to adjusting the risk weightings would be to incorporate the impact of lower risk mortgage portfolios in the setting of the Prudential Capital Ratio for a standardised ADI.

ANZ view

4. *The integrity of the IRB as a fact-based and comprehensive system of risk management should be protected. It is appropriate that APRA provide support to institutions to move to an IRB system, including prioritising accreditation for mortgage portfolios. ANZ cautions against a scaled-back approach to accreditation standards. This may have the unintended consequence of reducing capital held against risks that are not properly understood or*

[17] Interim report, 2-9.
[18] Interim report, 2-12.

managed. The objective should be to ensure that the prudential framework facilitates the creation of a level playing field for risk management. It should not be to force equalisation of the capital requirements without regard to the risk profile, risk management and risk infrastructure. (Refer also Attachment 2-16)

4. FUNDING

Household leverage

The Inquiry states that it believes that the systemic risk associated with bank exposure to the housing market should be further considered. It seeks further information on measures that might be taken to mitigate risks.

ANZ adopts a prudent approach to mortgage lending. This includes sensitivity buffers taking account of customers' living expenses and ability to service a loan. Currently we ensure our customers can cope with a 2.25 per cent interest rate rise. Australian home loan lending accounted for 39 per cent of ANZ group lending as at March 2014. In the six months to March 2014, the average loan was AUD345,000 at origination and the average loan to valuation ratio 71 per cent. 47 per cent of all mortgage customers were more than one month ahead on repayments (excluding revolving credit facilities). Individual provisions as a percentage of gross loans were 0.01 per cent.[19]

APRA's active approach to supervision is reflected in its recently released *Draft Prudential Practice Guide, APG 223 – Residential Mortgage Lending*. It sets out requirements relating to the risk management framework, origination loan types, security valuation, hardship, stress testing and lenders' mortgage insurance.[20]

ANZ supports the supervision and measures now in place to monitor risks to financial stability posed by housing. Banks have extensive risk management capabilities and models in place to manage this asset class. ANZ notes that assets, other than residential mortgages, are most likely to be affected by an economic downturn. Inappropriate policy or regulatory intervention could significantly affect economic growth, stability and the interests of borrowers and homeowners.

As the interim report notes, there are factors that suggest housing credit risk has not increased in recent years.[21] The level of household leverage has stabilised since 2008 at around 1.5 years of gross disposable income and is similar to that in some other advanced countries. Households are generally not constrained from borrowing amounts that *they can reasonably be expected to repay*. Australia's shift to a low-inflation, low-interest rate environment resulted in a one-off shift in household debt.

The RBA states that there is no evidence of systematic provision of credit beyond the amount that borrowers can be reasonably expected to repay.[22] It notes that house prices have risen in the four major capital cities, particularly Sydney; price rises have generally been modest outside the capital cities.

The interim report also raises the issue of whether housing lending 'crowds out' lending to business, particularly small business unsecured lending. As noted below, ANZ does not consider that this is the case and has ample available funding for business lending.

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[19] ANZ, "Half year results", results presentation and investor discussion pack, May 2014, p.76.

[20] APRA, *Draft Prudential Practice Guide, APG 223 – Residential Mortgage Lending,* May 2014.

[21] Interim report, 2-51-52.

[22] RBA, *Submission to the Inquiry into Affordable Housing*, Senate Economics References Committee, February 2014.

ANZ view

5. *ANZ adopts a prudent approach to mortgage lending and closely manages risks posed by housing under the close supervision of regulators. Banks have extensive risk management capabilities and models in place to minimise risk and this asset class receives significant management and Board focus. ANZ notes that assets other than residential mortgages are most likely to be affected by an economic downturn.*

Small and medium enterprises

The interim report seeks views on funding for small businesses, and how to address problems of information asymmetry affecting lending to the sector.

ANZ believes that small business banking competition is robust and will continue to intensify. We are actively competing to increase our share of this market, have ample funds available for lending to small business and creditworthy customers have ready access to finance. We seek to meet the diverse range of small business' commercial and personal needs.

ANZ has pledged to lend $2 billion to new small businesses in 2014. This represents a doubling of our 2013 commitment. ANZ also provides small business with unsecured lending, which we view as an integral component of our small business offering. Our lending products are available on a fully secured, partially secured or unsecured basis.

Specialised capabilities are needed to serve small business customers efficiently. Scale is important so that there is sufficient credit data to assess risk efficiently. ANZ has invested in systems and capabilities to allow us to compete vigorously while meeting prudent lending standards, and offer a wide range of products.

While ANZ is a strong lender to the sector and supports development of businesses, there are limits on the role of banks. Banks are required to lend prudently, reflecting their critical place in the financial system.

Pricing for small business lending appropriately takes into account relative risk. As indicated by APRA data, risks for lending to small business are materially higher on average than for lending to larger corporates or residential mortgages.[23]

Information asymmetry is a problem faced by lenders assessing the creditworthiness of small businesses that do not have the financial reports generally available to larger businesses. All providers of services face the challenges of understanding the credit risk of new customers and relatively higher risk of lending to businesses.

Comprehensive credit reporting (CCR) is a major improvement to the availability of information and will provide significant benefits to financial institutions, consumers, and small businesses over time. ANZ is implementing CCR systems and would expect the market will inevitably move towards the inclusion of SME lending in CCR.

To some extent, information for small business lending is now available on a reciprocal basis with some credit bureaus. For example, Veda offers a trade payment service in which information is available on creditors and the age trial balance for a customer.

The banking industry through the Australian Bankers Association (ABA) is also working on initiatives related to small business lending. These are a project to provide reliable reporting on lending to small business, and a project with CPA Australia to assist small business to understand lending requirements and how to apply for finance.

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[23] APRA, Financial System Inquiry Submission, 31 March 2014, p.79.

ANZ view

6. *ANZ has ample funds available for lending to small business and is providing ready access to finance to creditworthy customers. ANZ has invested significantly to improve lending to small business and better manage credit. The rollout of CCR, and other initiatives in train will improve availability of credit information and data on lending to small business. (Refer also Attachment 2-18, 2-68)*

Impact of superannuation and Basel III on funding

The Inquiry seeks further information on the effect of Basel III and larger pools of superannuation on bank funding, pricing and the ability to fund long-term lending.

ADIs have significantly increased the levels of both capital and liquidity during and post the GFC. This has occurred in part due to bank managements' decisions to strengthen balance sheets and in part due to changing regulatory requirements including the impact of Basel III.

The net impact of the future Basel III liquidity changes on the cost of funds is not possible to quantify precisely as it largely depends on the extent to which the market pricing, for deposits for example, adjusts. The net impact will be better known after implementation in 2015. The average cost of funds for an Australian mortgage however has increased relative to the Official Cash Rate by ~150 basis points compared to pre-crisis.

The quantum of superannuation funds will grow in future years as the minimum compulsory contribution increases to 12 per cent by 2023 and as assets accumulate. An increase in superannuation may result in less household savings sourced directly from bank deposits. Wholesale funding sourced from superannuation funds has different characteristics from retail deposits. Increasing the proportion of bank funding from superannuation may result in:

- ADIs' loan-to-deposit ratios increasing, as funds flow out of retail deposits into other forms of investment including wholesale funding.
- A reduction in an ADI's ability to fund term lending due to the lower levels of 'stickiness' displayed by wholesale funding relative to retail deposits. The magnitude of this impact depends on the contractual tenor of the particular investment (i.e. whether it is a short-term or long-term investment).
- If superannuation funds increased their allocation to fixed interest products, this would limit the impact of higher levels of superannuation funding on ADIs' ability to fund term lending. OECD data suggests that Australian superannuation funds have among the lowest allocations to fixed income among member countries.[24] Larger superannuation funds generally do not participate in the banks' Additional Tier 1 capital (AT1) instruments (such as preference shares and capital notes) largely due to the franked nature of those securities and the fact that the approach to benchmarking often applied by larger managed funds does not value the franking component.

ANZ view

7. *Higher levels of household superannuation savings may affect bank lending depending on banks' management choices and market developments. Increasing the proportion of bank funding sourced through superannuation funds from households' savings, rather than through retail deposits, would affect banks' ability to fund term lending. Term lending may be reduced due to*

[24] Refer to Figure 8 in www.oecd.org/pensions/PensionMarketsInFocus2013.pdf

the lower levels of 'stickiness' displayed by wholesale funding relative to retail deposits, depending on the contractual tenor of the particular investment.

5. SUPERANNUATION

The interim report observes little evidence of strong fee-based competition in the superannuation sector, and that operating costs and fees appear high by international standards. It also notes that superannuation policy settings lack stability, adding to costs and reducing trust in the system.

Stronger Super reforms, and other regulatory changes such as Future of Financial Advice (FOFA) reforms, are designed to promote competition and improve services to consumers. The Government is also seeking to implement default superannuation fund selection policy. The completion of this major program of reform will provide competition, disclosure and other benefits to consumers.

Stronger Super reforms were introduced in 2012 specifically to address issues relating to competition, including fee competition and transparency. Key components of the reforms include the MySuper and SuperStream reforms, and transparency measures. The reforms will be introduced in stages with implementation due to be completed by July 2017. In light of the policy objective of Stronger Super and the legislated timetable, any further significant reforms to address competition are premature and should be deferred until a review of the effectiveness of the reforms has taken place after 1 July 2017.

The reforms are already having a significant impact on fees. ANZ has responded to the MySuper reform by creating ANZ Smart Choice, one of the lowest-cost simple superannuation products for the default fund market.[25] Subject to trustee approval, all of our approximately 600,000 existing employer superannuation members will have transitioned into ANZ Smart Choice by 1 July 2017.

The Government has also stated that any MySuper product should compete freely in the default superannuation market.[26] If this policy is implemented, we expect that it will strengthen fee-based competition. New steps at this time, such as the introduction of an auction mechanism, would simply introduce further loss of confidence in the system.

The SuperStream reform is also intended, once implemented, to improve efficiency and promote competition in the superannuation sector. The reform aims to strengthen superannuation choice by making rollovers more efficient and effective, and will involve both large and small employers. The SuperStream reforms are expected to be completed by mid-2016.

Stronger Super has also introduced significant transparency measures including a new fee disclosure regime for superannuation funds. ANZ supports a consistent and transparent approach to fee and expense disclosure across the industry. Currently, different approaches across the industry limit consumers' ability to make informed decisions. ANZ will continue to work with the Government and regulators to achieve more consistent and better fee disclosure. Better informing consumers will improve competition and removing disclosure inconsistencies will reduce costs for consumers and their advisers.

These and related changes constitute some of the most significant regulatory changes since the inception of the Superannuation Guarantee in 1992. In addition to Stronger Super, the industry is implementing FOFA, Privacy, taxation and increased APRA reporting changes. The ABA has estimated that implementation costs for many of these

[25] ANZ Smart Choice Super was awarded *Money* magazine's 2014 Best of the Best award for the Lowest-Cost Default Super Fund.

[26] Assistant Treasurer, Senator the Hon Arthur Sinodinos AO, "Superannuation discussion paper released for comment", media release, 28 November 2013.

projects plus several others has cost seven banks (including the four major banks) AUD1.67 billion.[27]

ANZ believes that there are regulatory and taxation obstacles to adopting more efficient structures. Member contributions to many superannuation trusts (such as the ANZ Wealth's OnePath Master Trust) are invested through a 'master life policy' issued by a life insurance company. A more efficient approach would be a direct investing structure. Current rules discourage change because it would trigger capital gains liabilities. More efficient direct investment structures could be put in place if there were rollover relief. More generally, fund merger taxation relief would also promote greater efficiency.

ANZ endorses the Inquiry's observation that superannuation policy changes, and speculation about these changes, reduces confidence in the superannuation system.

ANZ view

8. *The Stronger Super reforms and government policy on default superannuation funds selection are designed to promote competition and reduce costs. The completion of this major program of reform will provide competition, disclosure and other benefits to consumers. A consistent and transparent approach to fee and expense disclosure across the industry would assist consumers to make informed decisions. Appropriate rationalisation regime for superannuation investment structures, products, and funds would also assist the industry in improving scale and efficiencies. (Refer also Attachment 2-114 to 2-126)*

6. STABILITY

Too Big to Fail and moral hazard

ANZ supports the view expressed in the interim report that government should minimise the expectation of taxpayer funds supporting the financial system, specific institutions or sectors. As noted in the report, government may intervene during a financial crisis to avoid disorderly failures, and a strong government balance sheet is important for this purpose.

ANZ's detailed response to this section of the interim report is contained in Section 2 of this paper.

Resolution powers and pre-positioning

The interim report seeks views on whether gaps in regulators' resolution powers should be addressed. These gaps include the ability to require restructuring of a regulated entity or resolve group distress, and a lack of statutory bail-in powers to impose losses on particular creditors. It also seeks views on whether more pre-planning for failure should be undertaken. It notes that these measures impose costs, but are likely to be relatively low-cost measures.

APRA states it has a relatively robust set of legal powers to enable it to respond effectively to financial distress. New legislative provisions have broadened the grounds on which APRA may appoint a statutory manager to an ADI and the power of statutory manager. APRA and Treasury are developing proposals to address some remaining gaps and deficiencies in crisis resolution powers.[28]

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[27] As stated at interim report, 3-93, the ABA has estimated costs for a set of major reforms at AUD1.7 billion (excludes Stronger Super). The superannuation industry would be affected by many of the reforms identified by the ABA. ANZ supports greater clarity about the costs of reforms.

[28] APRA, *Financial System Inquiry Submission*, 31 March 2014, p.60.

ANZ agrees that gaps in APRA's resolution powers should be addressed to enhance crisis management powers. A number of issues remain to be determined such as appointment of a statutory manager to a solvent non-operating company or subsidiary, and suspension of continuous disclosure obligations.

Appropriate pre-planning and pre-positioning for financial failure should be encouraged. This needs to be done in a targeted, economical and consultative manner. There are many potential scenarios and exhaustive preparation for all cases would be excessively costly for regulators and ADIs.

ANZ view

9. *ANZ supports certain measures to improve regulators' resolution powers and a greater focus on resolution planning and pre-positioning. This needs to be undertaken in a targeted and cost-effective manner. A number of difficult issues remain, such as appointment of a statutory manager to a solvent non-operating company or subsidiary, and suspension of continuous disclosure obligations.*

Capital requirements

The Inquiry seeks views on whether D-SIBs should be required to hold more capital.

The volume and quality of capital has increased materially since the GFC. As noted previously, major ADIs are now implementing capital management strategies to meet the D-SIB additional capital requirement prior to implementation in 2016. ANZ does not believe there has been sufficient change in the Australian financial system or the risk profile of Australian banks in recent months to warrant the revisiting of APRA's recent D-SIB assessment.

Regarding the Basel implementation of a leverage ratio, ANZ notes that APRA is yet to release a consultation package on this issue and is currently considering how this measure may be implemented in Australia. Whilst we acknowledge that a leverage ratio may provide some benefit as a 'back stop' measure, ANZ's view is that risk based capital requirements that appropriately reflect the different risk profiles of various credit exposures should remain the most relevant and binding risk quantification and capital metric. If a leverage ratio does become the binding constraint for an ADI, this may encourage riskier asset origination over low-risk assets. Furthermore, ADIs should not be penalised for increasing their holdings of high-quality liquid assets (i.e. for Basel III liquidity requirements).The current leverage ratio proposals do, *prima facie*, discourage this liquidity strengthening.

Much criticism of Risk Weighted Assets comes from countries who have not implemented the Basel framework and were at the heart of the Financial Crisis. In Australia, Basel II became effective on 1 January 2008 and work on implementation of this APRA requirement should be given credit in Australian banks' better understanding and pricing of risk. It can be expected that as experience with risk models has developed, anomalies in RWA calculations will be ironed out. This is a positive as banks and regulators have constructive supervisory discussions on the make-up of banks' balance sheets, and banks are encouraged and required to invest in better risk management. To abandon this for the leverage ratio as binding constraint would imply we have not learnt the lessons of the 1992 banking crisis.

See also ANZ's response in Section 2 of this paper.

'Ring-fencing'

The interim report seeks views on whether banks' critical functions should be 'ring-fenced'.

ANZ does not support 'ring-fencing' of particular activities within Australian banks and notes the strong arguments in the interim report against such measures.[29] To the extent that an Australian ADI in the future might undertake speculative activities placing taxpayers at risk, APRA already has existing powers to identify such activities and take action.

An argument in support of ring-fencing is that establishment of a Non-Operating Holding Company (NOHC) would enable a failed bank to be resolved more easily since core activities would already be separated.

Even with an NOHC, the corporate structure and systems operating across a major commercial bank are likely to be highly integrated, based largely on customer segment supported by bank wide functions (such as finance). The best way to improve resolution is directly through relevant planning for such an event.

We note that APRA's Level 3 Conglomerates Standards have confirmed that D-SIBs have effectively been ruled out of pursuing a NOHC structure.

The share of Australian banks' balance sheets employed in investment banking and proprietary trading is very low. For example and depending on the regulatory definition, pure proprietary trading as a share of ANZ group revenue would likely be as low as one per cent.[30] If considered necessary, the extent of banks' activity related to investment banking or proprietary trading might be monitored against a threshold level.

Foreign exchange and risk management are long-standing activities for Australian commercial banks. They are important for meeting the needs of Australian businesses. Ring-fencing would impose costs which would ultimately flow through to customers.

Implementing ring-fencing, even where it is a relatively small scale of activity, involves complex interventions. These would likely involve legislative, regulatory and business reviews, as well as potential dismantling and reconstruction of business activities and processes, information systems and legal structures. Infrastructure supporting business activities, such as management structure, would be required to be duplicated.

ANZ notes the estimates in the interim report of costs in the UK include a transition cost of around £3 billion, with ongoing costs of around £420 million to £1.9 billion per annum (0.04 to 0.16 per cent of United Kingdom GDP). Although the extent of relevant activity in Australia is low, ring-fencing would likely result in material costs and require similar steps as those taken overseas. Ring-fencing may not provide the claimed protections if points of failure exist within the protected assets or only become apparent just prior to a collapse. Pursuing ring-fencing would distract business and policy effort from other more important reforms and commercial goals.

Given the underlying strength of the Australian financial system and measures to increase resilience since the GFC, it is unlikely that ring-fencing would result in a discernable new benefit to offset the likely high costs.

ANZ view

[29] Interim report, 3-19.

[30] Ibid.

10. *Australian banks do not have the complex business models that ring-fencing of investment banking and proprietary trade activities is designed to address. APRA should continue to monitor banks to identify relevant risks or exposures.*

Macroprudential toolkits, prudential perimeter and stress testing

The interim report also seeks views on the value of macroprudential toolkits, whether regulators should have powers to extend the prudential perimeter and the importance of stress testing as a regulatory tool.

ANZ agrees with the interim report that that the effectiveness of new macroprudential tools is not yet well established, and there are significant practical difficulties in using such tools. APRA and the RBA have wide existing powers related to macroprudential management.

Institutions or activities that pose risks to the financial system should be able to be brought within the prudential perimeter if required. Public perceptions that government will step in to protect the interests of investors in institutions brought into the prudential perimeter may need to be considered. Early monitoring of institutions that potentially pose a risk would likely also be needed.

Stress testing is an important quantitative tool and a fact-based approach to assess systemic and institutional risk. It should be conducted in an efficient and consultative manner, and is one of a number of approaches that regulators should employ.

ANZ view

11. *APRA and the RBA have wide existing powers related to macroprudential management and the value of further macroprudential tools is unclear. Institutions or activities that pose risks to the financial system should be able to be brought within the prudential perimeter. Stress testing is an important tool for assessing risks and setting risk appetite. (Refer also Attachment 3-31)*

Implementation of international prudential standards

The interim report observes that Australian banks' capital ratios are around the middle of the range relative to other countries, noting that definitional issues limit comparability. It seeks views on whether Australia's prudential framework, in aggregate, should be more conservative than the global median, and the best approach to improving transparency of capital ratios.

Analysis places Australian banks well into the 75th percentile rather than 'the middle of the pack'. On this basis, the Australian prudential framework is more conservative than the global median.

ANZ notes that Chart 5.3 of the interim report, which suggests that the capital ratios of Australian banks are below 'global medians', is wrong. It does not incorporate:

- Differences that APRA has acknowledged are Basel III variations relating to Risk Weighted Assets for Mortgages and Interest Rate Risk in the Bank Book. These differences alone would lift Australian banks CET1 ratios by ~100bp to be above the global 'median'.
- Further Risk Weighted Asset adjustments caused by model inputs for the same risk being different across jurisdictions. While these are difficult to assess because they vary across jurisdictions, they do represent a further upwards adjustment for Australian banks (i.e. higher ratio for Australian banks). Accordingly these adjustments are not included in Table 5.2, but are estimated in the bank's own reporting against UK and Canadian peers. This represents an additional ~100 to 150

basis point impact (refer to slide 52 of ANZ's 1H14 Results Presentation & Investor Discussion Pack).

- Australian bank Additional Tier-1 and Tier-2 Basel II compliant capital securities. These securities are not Basel III compliant, as they do not include a Point of Non Viability conversion in contractual terms, but were granted Basel III transitional treatment by APRA over a nine-year phasing out period. The securities can be included in the capital base subject to an APRA-specified cap that reduces each year and is phased out by 2021. The Basel II compliant securities are replaced with Basel III compliant securities (i.e which include a PONV contractual term) as they are rolled over. Other jurisdictions took a different approach to that employed in Australia. Basel III PONV requirements were covered by changes to local statutes and hence Basel II compliant securities were deemed to be fully Basel III PONV compliant. Securities from these countries are included in Chart 5.3 whereas Australian's Basel III transitional equivalent securities have been omitted.

ANZ notes that two of the main differences with APRA's implementation of Basel III only impact major ADIs in any material sense. These differences are specifically capital for Interest Rate Risk in the Banking Book (IRRBB) and not recognising the 10 per cent allowance for investments in insurance subsidiaries and associated financial institutions. As a result, on an international harmonised basis the additional capital imposts on the major banks are, in effect, well in excess of the 1 per cent D-SIB.

In relation to the question of whether prudential settings should be more conservative than those of other jurisdictions, Australia weathered the crisis well and the validity of international comparisons should be questioned. ANZ believes that prudential settings should be determined by taking into account the structure, performance and risk associated with Australian banks. While comparison with international jurisdictions may be useful, it does not take into account the specific circumstances of Australia such as those outlined previously.

In relation to transparency of capital ratios, ANZ strongly supports any measures to increase the comparability of capital ratios across jurisdictions. It is critically important that the market, including debt and equity investors, understand a bank's capital position under both local prudential standards as well as on a basis that is comparable to other banks globally (such as reporting ratios on a Basel 'harmonised' basis). This has been a strong focus in ANZ's public disclosures in recent years.

The credibility of these disclosures will be further enhanced through agreed standardised templates, making these disclosures mandatory rather than optional, and explicit regulator endorsement or support of the disclosures. The industry is currently well progressed in these developments.

Greater comparability of capital positions will help ensure Australian banks are not disadvantaged in international capital markets (either through the cost of funding or availability of funding). This is particularly important should bail-in be introduced.

An example of the implications of inconsistent capital calculations occurred in a recent Bloomberg 'The World's Strongest Banks' article in which 40 per cent of the weighting was allocated to the reported Tier 1 capital ratio. Capital ratios are recorded on Bloomberg based on local regulations.[31] Differences between APRA and internationally harmonised approaches were not factored into the analysis, resulting in the incorrect conclusion that Australian banks are not strong.

ANZ view

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[31] See http://www.bloomberg.com/news/2014-06-15/hang-seng-bank-tops-list-of-strongest-lenders.html.

12. *Australian bank capital ratios are conservative. Prudential settings should be determined by taking into account the structure, performance and risk associated with Australian banks. ANZ strongly supports measures to increase the transparency and comparability of bank capital ratios across jurisdictions.*

Corporate governance

ANZ supports the interim report observation that sound corporate governance requires the responsibilities and authority of Boards and management to be clearly defined.[32] In recent times, expectations of the role of Boards appear to have increased, with Boards potentially being involved in the development of policies and detailed risk appetite settings, and ensuring these are implemented. In relation to the options in the interim report, ANZ considers that a short review would be valuable to ensure regulation is developed in a manner consistent with the distinction between Board and Management responsibilities established through the *Corporations Act 2001*, other relevant legislation and case law.

ANZ view

13. *Clarification is required to ensure that there is a proper distinction between Board and Management responsibilities within financial institutions. (Refer also Attachment 3-44)*

7. CONSUMER OUTCOMES AND CONDUCT REGULATION

Disclosure regime

The interim report observes that the "current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants". It sets out related options including using techniques such as layered and risk profile disclosure, removing ineffective disclosure, using new technologies, introducing new product design requirements, providing ASIC with additional intervention powers, and using default products.[33]

It is critically important that consumers understand their rights and obligations. However, complex statutory and case law defines these rights and obligations with the result that full disclosure involves great detail.

ANZ believes that a range of approaches and techniques are necessary to improve disclosure, and will make a separate submission to the Inquiry on this. No single approach will address all the issues.

- Electronic delivery of existing product disclosure information should be a priority. Information should be simplified as far as possible to make it shorter and more understandable when delivered electronically, and accompanied by links to long-form disclosure documents where required.
- 'Layered disclosure', that is providing information relevant to the particular customer need or transaction, is likely to be beneficial.
- Shorter and more tailored disclosure documents, such as the home loan key fact sheets under the National Consumer Credit Framework (NCCF) or the short-form PDSs under the FSR framework, provide customers with key product features in a simple and easy to read format. They are not, however, a substitute for full disclosure.

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[32] Interim report, 3-48.
[33] Interim report, p.xxxi.

- A multidisciplinary approach is needed for improving disclosure, including considering consumer behaviour, customer experience, legal and policy issues, and financial service provider operational impacts. Insights from behavioural economics may assist in setting priorities.

- A consistent framework for the disclosure of fees and expenses in superannuation and investments would assist consumers.

ANZ cautions against introducing further product design requirements. Product design regulation will not address the issue of ensuring that customers are placed in suitable products. A lesson from the GFC is that strengthening a financial institution's risk culture can go further towards protecting consumer interests than overly prescriptive disclosure requirements.

Product design is a proprietary decision and overly prescriptive regulation of products can stifle innovation. Experience suggests that agreeing on a mandated product design can be a slow process and uncertainty brings costs to the industry.

Disclosure relating to Additional Tier 1 instruments and powers exercised by the regulators in the UK relating to a retail moratorium on the distribution of hybrid capital instruments has been raised as an issue in FSI forums. The products are appropriate for investors with well-diversified portfolios and the majority of sales in Australia are through the broker and advice channels subject to disclosure and advice regulation. Recent ANZ transactions meet ASIC's disclosure requirements.

ANZ view

14. *Strategies are needed to improve disclosure, including 'layered' disclosure, simplification and prioritisation of electronic delivery. ANZ will make a separate submission on retail product disclosure to the Inquiry.*

Financial advice

The interim report observes that affordable, quality financial advice can bring significant benefits for consumers. It seeks views on options to improve adviser competence, meeting demand for lower-cost scaled advice and ensuring independent advice.

Increasing the minimum education standards applying to advisers will benefit consumers and the industry. We support continued work on a holistic minimum education and competency framework for advisers including through the establishment of a national exam.[34] An independent body should manage the development and running of the exam. The framework should include continuing education requirements as occurs in many other professions.

In addition, we agree that an enhanced public register of financial advisers will assist consumers. The government is currently consulting on how this could be achieved.[35]

Future of Financial Advice reforms establish the Best Interest Duty and regulate conflicted advice, aimed at ensuring that customers receive independent advice suited to their needs and circumstances. There are opportunities to provide more affordable, quality, and scaled advice within this framework by using digital technologies and other channels.

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[34] An example and possible model of a securities and adviser related examination is the US General Securities Representative Exam ("Series 7") administered by Financial Industry Regulatory Authority. Refer http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/Qualifications/P011051.

[35] Acting Assistant Treasurer, Senator the Hon Mathias Cormann, "Establishing an enhanced public register of financial advisers", media release, 17 July 2014.

Ensuring suppliers are clear and consumers understand expected returns and risks associated with particular investments and strategies should be a continuing focus. Regulators have an important role in explaining the policy and legal framework protecting consumers and where private investors assume risk.

ANZ view

15. *Consumer confidence in affordable, quality financial advice is important for the proper functioning of the retail investment market. The provision of financial advice can be improved by better accreditation, training and continuing education, an enhanced public register of advisors, and reviewing regulation to allow appropriate digital provision of advice. Raising consumer understanding of risks and returns associated with investment products should be a continuing focus for regulators and industry. (Refer also Attachment 3-72 to 3-74)*

Underinsurance and Life Insurance

The interim report acknowledges issues of underinsurance in Australia and seeks further information on the extent of the issue and potential policy options. Issues are raised in relation to general insurance and life insurance. The interim report asks if Australia has an underinsurance problem that warrants a policy response.

Life insurance protects people against risk of serious illness, disability and death. It is an important risk management function of the financial system.

Financial Services Council research, *Underinsurance Death Protection Gap in Australia*, released in April 2014, estimated the level of underinsurance of employed people against premature death to be AUD800 billion. The research also found that 19 per cent of families do not have any death insurance and Australians aged 18–29 are the most underinsured against death.

In the majority of cases, employed Australians have obtained life insurance through default arrangements in superannuation, with individual purchases of personal insurance making up the remainder.

In recent times, policy lapse rates and premiums have increased. High lapse rates place pressure on premiums as the pool of insured persons shrinks. Higher premiums, in turn, reduce affordability, potentially creating an adverse cycle of increasing lapse rates and reduced sustainability.

Two significant causes of rising premiums are the widening of grounds on which a person may be declared totally and permanently disabled under a policy, and increases in legal actions, particularly in relation to older claims.

Apparent product complexity and premiums that rise with age also contribute to high lapse rates. The approach taken by superannuation funds to providing life insurance can be improved to reduce pressure on premiums. For example, if more claims data and better information on risks of insured persons were collected and provided by superannuation trustees to insurers, pricing could be assessed more efficiently.

Insurers, through the operation of the market, have primary responsibility for making changes to meet consumer and superannuation fund requirements. Nevertheless, there are changes to the current rules and approaches that could improve the functioning of the market, affordability and coverage.

Early intervention and rehabilitation, as an alternative to potential permanent and total disability claims, could be encouraged. This would improve outcomes for individual consumers and, over time, improve life insurance affordability and take-up by reducing

pressure on premiums. This would involve changes to the *Private Health Insurance Act 2007* to allow life insurers to compensate for medical expenses for rehabilitation after accident or illness.

Limitation periods for actions commonly apply in areas such as motor accidents, work injuries and victim compensation. A similar approach should apply to life insurance; for example, limiting the age of claims to seven years (the applicable period for work injury claims in New South Wales varies with the longest period six years).[36]

Industry training and education of underwriters and claims assessors could be improved. Clear definition of disability related terms of conditions could assist consumers and providers. Improved advice to consumers and more affordable products available through digital technology would promote take-up.

Changing the rules and approaches as noted above can improve outcomes for consumers and increase the efficiency of the insurance market. It requires consideration of targeted changes, as well as cooperation between the industry, regulatory bodies and key groups such as superannuation funds.

In relation to general insurance, ANZ research on financial literacy has identified underinsurance risks and relatively low levels of insurance take-up amongst certain groups. Part of 'being good with money' is protecting assets, particularly those fundamental to well-being, such as a house and its contents.

The fourth ANZ Survey of Adult Financial Literacy found that 27 per cent people considered the level of cover when renewing a policy. This was a reduction of three per cent from the 2008 survey. It was a high number at a time when there was extensive media coverage of inadequate or inappropriate flood insurance.[37]

The survey found that one in five people who owned or were purchasing their home did not have building insurance and one in four of those who owned, were purchasing or renting their home did not have contents insurance. Those least likely to have contents insurance were under 35, on incomes lower than AUD65,000 a year, in casual employment and, in the case of contents insurance, single parents. In other words, groups least well positioned to recover from asset loss or damage have the lowest incidence of insurance holding.

ANZ supports continued work on financial literacy, including underinsurance, led by ASIC, coordinating across government, and in partnership with not for profit groups and industry.

ANZ view

16. *The effectiveness of the life insurance market, coverage and affordability can be significantly improved with targeted changes, and a cooperative approach between the industry, regulatory bodies and key groups such as superannuation funds. ANZ supports continued work on financial literacy, including underinsurance, led by ASIC, coordinating across government, and in partnership with not for profit groups and industry. (Refer also Attachment 3-82 to 3-87)*

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[36] Lawcover, *Schedule of limitation periods in civil matters in New South Wales*, 20th Edition current at August 2013, p.4.

[37] ANZ, *Adult financial literacy in Australia*, Executive summary from the results of the 2011 ANZ Survey, December 2011, p.7.

8. REGULATORY ARCHITECTURE

Accountability

The interim report seeks views on options to improve accountability such as periodic independent reviews of performance, clarifying metrics, or improving oversight.

ANZ wishes to emphasise the importance of transparent cost benefit analysis of major changes, and appropriate accountability measures at different stages of the regulatory process. Substantial measures to change regulation or address risks to taxpayers should be carefully evaluated through transparent cost benefit analysis and regulatory impact statements.

Evaluation processes of the required thoroughness are costly and time-consuming. However, the costs are very small compared to the impacts on assets in the Australian financial system and the potential costs of an error to the economy and customers.[38] With ADIs holding risk-weighted assets of AUD1.67 trillion and a capital base of AUD204 billion at the end of March 2014, a small improvement in decision-making has significant benefits.[39]

Formal evaluation of a major regulatory proposal would be consistent with 2014 *The Australian Government Guide to Regulation.*[40] The Guide states that a formal cost benefit and detailed presentation of costs and offsets is appropriate where changes have substantial or widespread impact on the economy, as is the case for significant changes to rules affecting financial institutions.

Changes can more effectively be prioritised and successfully implemented with better evaluation. Policy 'reforms' or 'initiatives' have opportunity costs and only a limited number can be successfully implemented by industry and regulators at one time.

As the interim report notes, it is currently difficult to assess benefits and costs of regulation.[41] Thorough regulatory impact statements and quantitative cost benefit analyses have not been undertaken for many recent regulatory reforms. It is unsurprising that information is currently quite limited.

The extent of 'due diligence' and quantitative assessment should reflect the level of resources potentially affected, as should be expected in the normal course of commercial decision-making or risk based regulation. A tiered approach to cost benefit analysis would promote the Inquiry's goals without imposing unnecessary administrative costs.

ANZ view

17. *ANZ emphasises that the Government and regulators should conduct transparent cost benefit analysis of major regulatory changes, and ensure appropriate accountability measures at different stages of the regulatory process. Consistent with the Inquiry's principles of transparency and accountability, as well as government policy, long-form regulatory impact statements should be recommended for significant new rules, or changes to rules, affecting the financial system. Guidelines should be established*

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[38] See recent debate on deflation risks and the Swedish monetary policy: Wolfgang Münchau, "What central banks should do to deal with bubbles", Financial Times, July 13, 2014; and Lars E.O. Svensson, "Why Leaning Against the Wind Is the Wrong Monetary Policy for Sweden", at http://larseosvensson.se/research/. Professor Svensson, a former Deputy Governor of the Riksbank, argues that an early increase in Swedish interest rates to address concerns about housing risk reduced inflation substantially below target, and increased real household debt, unemployment, and risks to financial stability.

[39] APRA, "APRA releases quarterly authorised deposit-taking institution (ADI) statistics for March 2014", media release, 27 May 2014

[40] Department of the Prime Minister and Cabinet, *The Australian Government Guide to Regulation*, 2014.

[41] Interim report, 3-93.

indicating the expected thoroughness of evaluations, including quantitative assessment. These requirements should be related to the potential impact on financial assets and flows.

Accountability should be exercised at a number of stages of regulation:

- *Ex ante*: As noted, a comprehensive set of objectives and transparent processes to evaluate regulatory impacts are needed. The thoroughness of evaluation should reflect the value at risk from regulatory changes.

  Ex ante cost benefit analysis is also important because once regulation is implemented, it is complex to 'unscramble' activities to identify the effects of a change. In dynamic markets, the particular benefits of a policy change are similarly difficult to isolate.

- Means to undertake a merits-based or other third party review of particular decisions under regulation should be in place, with the exception of decisions responding to a crisis. To avoid an overly legalistic process, a reference panel operating under the supervision of the Council of Financial Regulators may be appropriate.

- *Ex post*: Appropriate outcome based metrics for regulators, post implementation review of specific changes, and a periodic sector wide review of outcomes are appropriate.

- The government's program to audit regulatory costs and establish quantitative targets to eliminate unnecessary regulation are valuable.[42] A continuing and disciplined approach is needed to retire obsolete reporting and rules, reducing costs to regulators, businesses and consumers.

ANZ view

18. *Market efficiencies would arise from improved accountability mechanisms established before regulation is implemented, during the operation of regulation and to evaluate outcomes. Targets for removing obsolete regulation are important and should be maintained. (Refer also Attachment 3-121 to 3-129)*

Regulator mandates

While the interim report observes that regulators' mandates are well defined, the report suggests that more can be done to emphasise competition matters.

Regulators' statutory objectives currently vary considerably allowing wide scope for different interpretations. As set out in the Attachment, we consider greater weight should be placed on economic growth, international integration, the interests of end customers, and providing guidance to the public on risk associated with different forms of investment. ANZ believes that it would be valuable for the Inquiry to expand its framework for regulatory objectives; for example:

- A set of overall objectives for the financial system similar to those set out for the RBA or elements of the ASIC statutory objectives and which provide guidance for regulators. This should be centred on maximising economic welfare, consistent with a financial system that is stable, reliable, fair and accessible.

- Descriptions of the particular roles and objectives of each regulatory institution in meeting overall objectives, such as the RBA role in monetary, banking and payments,

[42] See http://www.cuttingredtape.gov.au/

APRA's role in prudential supervision and ASIC in regulation of markets and market conduct.

- The approach to achieving overall and regulator specific aims. This should include the principles articulated in the interim report related to removing barriers to competition and promoting allocative efficiency.
- Matters to be considered in regulatory decision-making, including the international competitiveness of Australian business, the interests of consumers, and opportunities for growth and trade. This may also recognise, as the Inquiry has, the importance of risk-taking in innovation and growth.
- The approach to managing risk associated with public investment in different asset classes or types. This should include continued emphasis on improving public understanding of the nature of risks and government support for different types of investment.

An overall goal related to the stable growth of the economy and recognition of the importance of innovation is particularly important for setting public expectations. It would counter the incentives facing policy makers and regulators to place disproportionate weight on risk reduction. Australian policy makers and regulators have been successful to date in balancing growth and stability. Nevertheless, there are incentives to reduce risk because the price of failure is very public, but the costs of conservatism – reduced growth, reduced access to funding and higher rates – are largely hidden.

ANZ view

19. *Regulators should be given a clear mandate that their role is not only to ensure a stable and well-functioning financial system, but also to facilitate economic growth. The framework articulated in the interim report is strong but could be refined by more closely defining overall objectives for the financial system and each regulator, the approach to achieving these objectives, matters that should be taken into account in regulatory decision-making and risk associated with investment in different asset classes. (Refer also Attachment 3-121)*

9. RETIREMENT INCOME

The interim report observes that the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees. It seeks views on options to position Australia to manage the challenges of an ageing population. It suggests options such as incentives for, or mandating of products, to manage longevity and other risks, default product options, and reverse mortgages.

Australia has developed a strong framework through compulsory superannuation, the Age Pension and voluntary saving. The aim of compulsory superannuation is to provide retirement savings for people that will give them an overall retirement income higher than the age pension alone can provide. The Age Pension is targeted to those most in need while ensuring there is an incentive for self-provision through working and saving.[43] Taxpayers underwrite some risk through the age pension and aged care.

The policy focus has been on accumulation of savings. Retirement outcome related policy is relatively underdeveloped. Retirees face a range of risks including market returns and sequencing (i.e. early adverse market returns disproportionately impacting future wealth), longevity, inflation and market liquidity. Their circumstances vary widely in

[43] See Australia's retirement income system at http://www.treasury.gov.au/Policy-Topics/SuperannuationAndRetirement/supercharter/Report/Chapter-1

terms of assets, incomes, family and community support, estate planning goals, health and care. Information to inform decisions can be complex.

Increases in Australians' life expectancy have particular implications for industry ability to develop and price products, individuals' retirement incomes and government policy.[44] Capital requirements for traditional annuity products are high and likely to increase.

Clearer information and the development of better products suitable for the life-time of retirees are needed. Customers' understanding of the costs of providing lifetime incomes, and long-term rates of return appear low. They are reluctant to pay for products such as lifetime annuities. A low interest rate and low growth environment exacerbates this problem. The ability to develop annuity products is limited because there has been no Australian long-term bond market for hedging risk.

There is debate about the extent of risk to the fiscal position of government and taxpayers over the long term, as well as to individuals and communities. It would be prudent to assess the extent of the risks systematically, to allow more sustainable policy to be developed and improve outcomes for retirees.

Better options and products are needed to manage the risks faced by retirees, and through that to taxpayers. Rules for superannuation, taxation and social security support have complex interactions which should be examined. As far as possible, incentives and market solutions are to be preferred, taking into account individual circumstances.

Policy options that could be explored include industry pooling of experience, or greater risk pooling, options for reinsuring long tail longevity risk (although this is unlikely to be very costly) and establishing set ages for particular products. Taxpayers are today partial insurers of longevity risk and may have a role in underwriting risk in pooled arrangements.

Reverse mortgages allow retirees to access wealth in what is often their most substantial asset. There are no regulatory impediments to the development of these products. The risks to retirees associated with these products are significant. Retirees should receive appropriate advice consistent with the regulatory framework applying to these products.[45]

ANZ view

20. *Retirement income policies need to be reviewed to ensure the market provides appropriate products and clear information to address the needs of retiring Australians. Rules for superannuation, taxation and social security support have complex interactions that should be examined in order to maximise benefits for retirees and to reduce the burden to the greatest extent possible on taxpayers. (Refer also Attachment 4-31 to 4-33)*

10.TECHNOLOGY

The interim report raises issues related to technologically neutral regulation of financial services, privacy and management of data, and cyber-security.

ANZ believes that cyber security is a priority issue as financial services shift to mobile and online channels. A review and update of the 2009 Cyber Security Strategy should be undertaken. It should include models for collaborative information sharing, potential joint response to threats and a cyber-security framework.

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[44] See longevity discussion in Actuaries Institute, Submission to the Financial System Inquiry, 30 March 2014.
[45] See ASIC, *Regulatory Guide 209 Credit licensing: Responsible lending conduct*, September 2013.

ANZ fully supports a national strategy for promoting trusted digital identities, in consultation with financial institutions and other stakeholders. Financial institutions rely heavily on government-issued credentials. A formal, standardised model and mechanism for electronically authenticating individuals is required.

ANZ agrees with the interim report observation that technological innovation is a major driver of efficiency in the financial system and can benefit consumers. Key issues relate to barriers to digitisation and technology neutrality, privacy and cyber-security. Government and industry collaboration is required to manage these issues in the interests of stability, consumers and business.

Technology neutrality is an important principle. Digital and mobile technologies and new applications will reshape the financial services industry. Obstacles to developing new services and customers' choice should be minimised as far as possible, consistent with a sound and well-regulated financial system. Regulation should not entrench existing products or distribution channels.

There are opportunities to promote technology neutrality by removing obstacles to digital services, such as restrictions on the use of digital channels to verify or contract with customers. An audit of barriers to digitisation with the aim of setting policy priorities would be valuable.

Privacy is a critical consideration in digital services and the new privacy regime should be allowed to bed down. Current privacy laws offer adequate protections in relation to record keeping and privacy requirements (noting that cross-border information flows and different national regulatory approaches continue to be an issue). Consumers can access non-commercially sensitive information about their business although they may not be aware of their rights.

ANZ view

21. *Cyber security is a priority for the industry as financial services shift to mobile and online channels. The Cyber Security Strategy should be reviewed and industry-regulator collaboration on security matters encouraged. A national strategy on digital identities is important. Technology neutrality is an important principle and there are opportunities for removing obstacles to digital services. The new privacy regime should be allowed to bed down. Issues about cross border transmission of information should be reviewed. (Refer also Attachment 4-41 to 4-71)*

11. INTERNATIONAL INTEGRATION

ANZ strongly supports the focus of the interim report on the integration of Australian and global markets in a manner that is consistent with stability goals. It benefits businesses in the real economy and national productivity.

International integration and the Asian growth opportunity

The interim report notes that Australia has benefited from financial integration with the rest of the world[46] and supports greater integration. It includes, for consultation, options for improving coordination of international integration.[47] ANZ supports the approach of the interim report on international integration.

The Inquiry has noted that Asian growth will represent half of world growth in the next decade and will account for 50 per cent of global GDP by 2050. The ANZ submission

[46] Interim report, p.1-28.
[47] Interim report, p.4-99.

argued that this massive growth of Asian economies and their financial systems represents the principal economic opportunity for Australians and financial markets.

Technological change, the removal of trade barriers and the growth of emerging economies will drive international integration. As this occurs, it will become more important for Australian policy makers and regulators to understand and support the international competitiveness of Australian businesses.

ANZ view

22. *Economic and productivity growth will be maximised if Australian businesses are internationally competitive and able to adapt to change. Regulation of the financial system should assess and take into account the impacts of regulatory settings on costs to Australian businesses when making decisions.*

Contribution of financial services to international trade and integration

The contribution of the financial services sector to international integration should also be further considered. This cannot be done using financial services export statistics. The principal vehicle for offshore expansion by financial institutions is through offshore investments, rather than through service exports directly from Australia. Export statistics do not take into account income from offshore investment, only direct exports. As a result, the contribution of the financial services sector to international integration is usually systemically underestimated.[48] [49]

The Australian financial sector holds AUD140 billion direct foreign investment, concentrated in traditional markets rather than in the growth markets of Asia.[50] It represents 28 per cent of Australian foreign direct investment just behind the mining sector at 29 per cent.[51] The importance of offshore presence will continue to grow since governments and customers will expect foreign institutions wishing to conduct business in their country to have a local presence and investments.

ANZ considers that the Inquiry should recommend that policy makers and regulators take impacts on the international competitiveness of Australian businesses into account in decisions. This will help ensure that regulatory decisions, within appropriate prudential

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[48] The most recent study was *Australia's Outward Finance and Insurance Foreign Affiliates Trade in Services*, Department of Foreign Affairs and Trade (DFAT), 2009–10. The WTO classifies four modes of supply of services. 'Mode 3' is income from commercial offshore presence, as distinct from 'mode 1', cross-border trade of services, 'mode 2', services consumption while offshore, and 'mode 4', presence of natural persons offshore. Financial services export measurement excludes mode 3, that arising from offshore investment, even though this appears to be the most important mode.

[49] ANZ Asia Pacific Europe and the America presented 24 per cent (AUD2.3bn) of ANZ group income in the first half of 2014. This indicates that ANZ alone is of the order of double the annual AUD2.4bn financial services exports from Australia in the 2013 full year (ABS. 5368055004, Table 5.7).

[50] The August 2014 RBA research discussion paper, *International Trade Costs, Global Supply Chains, and Value-added Trade in Australia* (Gerard Kelly and Gianni La Cava) notes that mining and other primary exports from Australia are used as intermediate goods which are ultimately destined for the US and Europe. It notes that on a value added basis, the US and Europe are the ultimate destinations for most Australian resource exports once embedded in final products. It also notes the important role of services as intermediate inputs to resource exports.

[51] See ABS 53520 - *International Investment Position, Australia: Supplementary Statistics, 2013*, 1 May 2014. Taxation statistics may also be used to provide additional insights. *Taxation statistics 2011–12, Company tax: Selected items, by industry, 2011–12 income year* report net foreign earnings for Financial and Insurance Services companies of AUD4.8 billion, including central banking. The RBA annual Reserve Bank of Australia Annual Report 2012 reports net profits on foreign interest and securities of AUD527 million (refer note 2 to the financial statements). Noting that that these numbers may not be strictly comparable for accounting purpose, they lead to the estimate of AUD4.3bn net foreign earnings for Financial and Insurance Services excluding central banking. The reported total company taxable income (including exports directly from Australia and domestic income) of Oil and Gas Extraction companies was AUD3.3 billion and Agriculture companies AUD 394 million in that year.

bounds, are not solely focused on domestic issues and contribute to broader national economic and productivity growth.

Approach to promoting international integration

The Australian G20 is an important opportunity to promote international integration. As noted earlier, the work of the B20 provides insight into obstacles to promoting international integration and supporting improved growth. Key themes of the G20 work are structural flexibility; free movement across borders of goods, services, labour and capital; consistent and effective regulation; and integrity and credibility in commerce.

Examples of impediments to further integration include national divergences in regulation particularly in relation to prudential regulation, market access barriers, constraints on cross border data storage and flows, taxation rules affecting offshore financial flows, and unforseen impacts of new standards. Continued government support and engagement can help address these problems and take advantage of market liberalisation.

Government and regulators play a critical role in promoting international integration. Domestic regulators are in a position to increase mutual recognition or address cross border issues such as resolution processes or movement of data. The Australian Government, regulators and industry can promote integration in international and regional forums.

Coordination body

The interim report asks if an existing coordination body should be given specific accountability for promoting international financial integration and providing advice to government. ANZ supports this suggestion. Relevant functions might include to:

- Provide advice to government, Treasury and the regulators on priorities, opportunities and risks, and coordinate the development of plans and priorities.
- Assess and report on the efficiency, level and nature of financial system integration.
- Report on relevant global, regional and domestic financial policies and regulations and their impact.
- Provide advice on the impacts of taxation, national governments' external and industry policies, and other non-financial policies.
- Assess the interests of different international and national regulators, including in emerging markets, and develop approaches to harmonise regulation.
- Assess the cumulative impacts of regulation on outcomes for businesses and consumers.

ANZ view

23. *Promoting international integration, consistent with stability objectives, is important for economic growth and an existing body should be given specific accountability for this function. (Refer also Attachment 4-88 to 4-98)*

12. TAXATION

The Inquiry makes a range of observations about the impacts of taxation on the financial system but notes that it is not its role to make recommendations on tax issues. It will provide its observations to the Government's forthcoming Tax White Paper.

In its submission, ANZ focused on the relatively low attractiveness of Australia as a base for multinational activity, and particularly that dividends from offshore profits are subject to full Australian tax as well as being taxed in the location in which the profits were derived. This bears on the central issue of the international competitiveness of the Australian tax system, and the impact this has on national economic and productivity growth.[52]

As also noted in the initial ANZ submission, current tax laws do not allow Australian ADIs to issue Additional Tier 1 instruments that are tax deductible with the result that offshore issuance is uneconomical. Overseas jurisdictions, including most of Europe, United Kingdom, Singapore, Japan and New Zealand, have moved to permit Additional Tier-1 securities to be tax deductible. Australia should take the same approach to ensure Australian banks remain internationally competitive on pricing and access to financial markets.

As noted previously, the interaction of taxation, retirement incomes and social security systems create complexity and economic efficiency. Given the complexity of taxation reform and its fundamental impact on growth, these issues should be dealt with through the White Paper process.[53]

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[52] The Treasurer, the Hon. Joe Hockey stated at the Sydney Institute ("A Budget For Opportunity", speech, June 11, 2014): "Company tax is our second largest source of revenue. Less than one per cent of companies pay 62 per cent of all company tax. In fact just 12 companies in Australia pay one third of all company tax. These companies constantly argue that our tax system is unfair because our tax base is vulnerable to increasing global competition with significantly lower rates in the United Kingdom (21 per cent), Singapore (17 per cent) and Hong Kong (16.5 per cent). Our tax base is facing significant headwinds and that is why the Prime Minister promised at the last election to deliver a taxation white paper after widespread community consultation."
ANZ notes the imputation system is effectively a pass through regime with respect to dividends from domestic profits distributed to domestic investors. For this class of income and taxpayer, it eliminates double taxation of dividends and creates neutrality with interest paying assets. The impacts of double taxation arise with respect to dividends from offshore investments paid to domestic investors. A relatively high corporate tax rate impacts retained company earnings, and potentially foreign investors (subject to rules in their home jurisdiction).
Rimmer et al estimated that a company income tax cut from 30 to 29 per cent would increase the level of GDP by between 0.15 and 0.35 per cent in the long-run. Company tax reductions produce larger welfare gains than available from cutting the other major taxation sources and that in the long-run the majority of benefits accrue to households through higher incomes. This is consistent with work for the Henry Tax Review.

[53] For a broad overview of key taxation issues facing Australia see Rob Heferen (Executive Director, Revenue Group, Treasury), "Tax Policy Challenges in a Changing World", F.H Gruen Lecture, ANU, Wednesday 1 August 2012; and "Implications of Digitisation for the Australian Tax System", speech to the 2014 Economic and Social Outlook Conference, Melbourne Institute, Friday 4 July 2014.