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FINANCIAL SERVICES

Financial System Inquiry

KPMG Final Submission

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26 August 2014



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Mr David Murray AO
Financial System Inquiry
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Dear Mr Murray,

Financial System Inquiry – Final Submission

KPMG welcomes the opportunity to present our final submission to the Financial System Inquiry (FSI) Panel.

KPMG's first submission focused on five themes we consider to be prerequisites for a stable, efficient and competitive financial system that meets the future needs of the Australian economy:

- improving our regulatory framework to better balance stability, growth and efficiency;
- promoting greater regional integration and regulatory harmonisation with Asia;
- enhancing diversification of funding and supporting superannuation investment in long-term asset classes;
- re-purposing the superannuation system to better address longevity risk; and
- enabling the take-up of digital and new payments services to boost productivity and addressing emerging technology risks.

KPMG is pleased that these themes have been addressed in the Interim Report. In providing further detail to our initial submission, we have concentrated our efforts on a selection of key issues we believe require greater attention.

KPMG considers that there is a need to assess the cumulative impact of regulation (taking into account costs and benefits) across all regulatory agencies, so that compliance costs, deflection of management time and efficiency impacts can be properly assessed across each sector of the financial services industry.

In terms of taxation matters, the Report indicates that consideration of the taxation issues will be deferred to the Tax White Paper process. We believe this risks missing an opportunity to provide Government with guidance on tax issues that are specifically relevant to the financial system. There is also the risk that these issues may be overlooked during the Tax White Paper process, given their materiality to the overall tax system.

KPMG has also provided further commentary in respect of options to address 'too big to fail', efficiency in superannuation, and greater competition and engagement within the superannuation sector.

KPMG would be pleased to provide further information to the Inquiry Panel that would assist you with your deliberations. Should you require this information, or have any questions, please do not hesitate to contact Rachel Merton, Head of Government Relations, on 02 9455 9109 or at rmerton@kpmg.com.au.

Yours sincerely,

Adrian Fisk
Partner, Head of Financial Services

Ian Pollari
Partner, Head of Banking

KPMG Final Submission

Improving our regulatory framework to better balance stability, growth and efficiency

Assessing the cost and impact of regulation

In Australia, as globally, there has been a substantial increase in the scope and intensity of prudential and market conduct regulation since the Global Financial Crisis (GFC). Authorised Deposit-taking Institutions (ADIs), insurers and superannuation schemes, in particular, have been impacted by the introduction of new or expanded prudential regulation and associated supervision. Examples have included: Basel III, the Internal Capital Adequacy Assessment Process (ICAAP), the Financial Claims Scheme (FCS) and stress testing for ADIs; Life and General Insurance Capital (LAGIC) requirements for insurers; the new full suite of prudential requirements for Registrable Superannuation Entities (RSEs); and, more recently, the development of comprehensive risk management and governance requirements for entities supervised by the Australian Prudential Regulation Authority (APRA). While many of these prudential requirements have been driven by international initiatives, such as those promoted by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), many have been promoted independently by APRA (see table on page 3).

KPMG has no doubt these regulatory requirements are justified in terms of potential financial stability benefits and enhanced protection of depositors, policyholders and beneficiaries. However, the new or expanded requirements have added substantially to financial institutions' already significant compliance costs. Some of the additional compliance burdens are temporary, such as the one-off development of IT functionality associated with new prudential requirements. Others are of an enduring nature and add materially to the overheads of financial institutions.

They also risk deflecting boards and management from other tasks, including strategic decision-making, new product development, market innovations and responding to customer needs. Regulatory requirements also carry a risk of imposing efficiency costs on financial institutions and reducing the overall efficiency, responsiveness and dynamism of the financial system. We believe in order to effectively understand the cost and benefit equation of regulatory proposals, much better information on the actual cost of the regulatory change is required.

KPMG does not have complete data on these compliance costs and efficiency impacts. What information we do have is partial and, in some cases, anecdotal. Below, we provide some examples of costs obtained via KPMG internationally in relation to the insurance and banking sector (from other countries).

In our view, a comprehensive stock-take of all financial sector regulation, across each industry within the financial sector, differentiated by type of regulation (including prudential, market conduct and anti-money laundering (AML)) is needed. The stock-take should be undertaken on a consistent basis using a standardised framework. It would also need to differentiate between one-off costs and ongoing costs.

In addition, KPMG recommends that all regulations be subject to comprehensive, industry-wide review at regular intervals (for example, every five years). This would allow for an assessment to be made of the cumulative impact of regulation (taking into account costs and benefits) across all regulatory agencies. We suggest that such a process should be overseen by parties other than the regulators – potentially led by Treasury, with assistance from the Productivity Commission. The process could then be used to inform a review of regulations by assessing costs against the benefits (public and private) associated with particular regulatory initiatives. This process could then be used to assess the scope for possible scaling back of some regulatory initiatives, removal of unnecessary duplication and recalibration of regulatory requirements where appropriate, while still ensuring that regulation remains effective in meeting statutory objectives.

KPMG also sees a need for a more thorough, ongoing process for undertaking cost/benefit analysis of all regulatory proposals. The current arrangements would benefit from greater transparency of analysis, more stakeholder involvement and more verifiable, quantitative impact assessment than is currently the case.

Volume and industry impact of new regulation (local and global)

Source	Regulator	Legislation/ Reform	Timeline											Impacted Sectors			
			2013		2014				2015				Banking	Superannuation	Wealth	Insurance	
			JUL SEP	OCT DEC	JAN MAR	APR JUN	JUL SEP	OCT DEC	JAN MAR	APR JUN	JUL SEP	OCT DEC					
BCBS	APRA	Capital			D-SIB requirements start Jan 2016. Leverage ratio disclosed Jan 2015.								✓				
BCBS	APRA	Liquidity			Submissions for CLF with approval by September.				LCR commences 1 Jan 2015				✓				
BCBS	APRA	Conglomerates Policy											✓	✓	✓	✓	
BCBS, FSB, IAIS	APRA	Recovery & Resolution Planning									Going forward, also likely to apply to large insurers		✓				
BCBS	APRA	Financial Claims Scheme			Reporting & Comms reqs		APRA may permit transitional arrangement							✓			
BCBS	APRA	Risk Management & Governance											✓	✓	✓	✓	
BCBS	APRA	Securitisation					Revised prudential framework						✓				
BCBS	APRA	Counterparty Credit Risk					Internal model method recognition						✓				
FATF	Austrac	AML/CTF/FATF & Anti Bribery	Revised customer due diligence rules										✓	✓	✓	✓	
BCBS	APRA	ICAAP											✓	✓		✓	
IOSCO, FSB	ASIC	OTC Derivative Reform	Phase 1 Entities	Phase 2 entities		Phase 3 entities	Clearing & Margining Requirements						✓	✓	✓	✓	
IRS	ATO	FATCA											✓	✓	✓	✓	

BCBS	Basel Committee on Banking Supervision
APRA	Australian Prudential Regulation Authority
Austrac	Australian Transaction Reports and Analysis Centre
ATO	Australian Taxation Office
IAIS	International Association of Insurance Supervisors
IOSCO	International Organisation of Securities Commissions
IRS	Internal Revenue Service of the United States
FATF	Financial Action Task Force
FSB	Financial Stability Board

	Implementation
●	Deadline for compliance

Key

Source: KPMG (2014)

In 2011,¹ KPMG internationally estimated that the additional cost of regulation to the global insurance sector, due to bespoke requirements in each jurisdiction, was in the region of US\$15 billion to \$25 billion per annum.

Last December, KPMG member firms conducted an online survey on the possible costs and potential benefits of global regulatory change², in particular, the development by the International Association of Insurance Supervisors (IAIS) of their ComFrame³ proposals.

¹KPMG International, *Evolving Insurance Regulation*, March 2011.

² KPMG International, *Evolving Insurance Regulation*, March 2014.

³ ComFrame is designed to develop a common framework for the supervision of Internationally Active Insurance Groups (IAIGs).

In the survey, KPMG asked firms to provide an estimate regarding the current resourcing costs specifically devoted to regulation, including management time spent on regulatory matters, as a percentage of Gross Written Premiums (GWP). Most estimates ranged between 1 to 2 percent of GWP, while other estimates ranged from 5 to 10 percent, to as high as 40 percent. Our own inquiries with Australian clients suggest that a range of 2 to 5 percent of GWP would most likely represent their current annual costs. Based on APRA's 30 June, 2013 data⁴, the annual GWP and premium income in Australia is approximately \$79 billion,⁵ which, on these estimates, would equate to a regulatory annual cost for Australian insurers in the range of \$1.6 billion to \$3.9 billion.

In 2012, KPMG Netherlands, conducted a study into the effects of 38 regulatory measures impacting the Dutch banking sector, as well as quantifying the cumulative effects of the most far-reaching measures (e.g. Basel III, bail-in debt).⁶ The study showed that whilst, on the one hand, the total number of existing and new regulations limited risks, created more transparency and led to better information provision, on the other hand, the measures led to a reduction in lending capacity, an increase in the cost of lending, and fewer options for banks' clients.

Too big to fail

One of the main themes in the Interim Report is the issue of 'too big to fail'. This has been a major issue internationally in the financial services industry since the GFC. The FSB, Basel Committee and other international bodies have made concerted efforts to address this issue, as have the governments of many jurisdictions, including in the United States and European Union. Australia is by no means immune to the 'too big to fail' challenge, however, it is imperative that the policy options are considered carefully and with due attention to the benefits, risks and costs.

The options for consideration in the Interim Report include:

- strengthening recovery planning requirements for financial institutions;
- introducing resolution planning requirements for at least the systemically important financial institutions to facilitate least-cost resolution;
- establishing some form of bail-in of subordinated and senior unsecured debt;
- setting higher capital requirements for systemically important financial institutions;
- separating, or facilitating the separability of, systemically important functionality from other business functions; and
- establishing a resolution fund.

KPMG notes that each option entails costs and risks which need to be weighed against the potential benefits, while considering the low probability of a large institutional failure. Hence it is important not to impose excess compliance and efficiency costs on an ongoing basis for risk events with a low probability of occurrence. We see a need for further work in this area, preferably under the direction of the Council of Financial Regulators (CoFR), in thorough consultation with industry and other stakeholders. To that end, we see merit in the FSI recommending that the Treasurer commission the CoFR to prepare a comprehensive report on the options for addressing too big to fail, including its assessment of the efficacy, benefits, costs and risks of each option, for consultation with stakeholders, and with recommendations to the Government on least-cost options.

We will examine some of these options in further detail below.

Recovery and resolution preparedness

KPMG recognises the importance of Australia having an effective policy framework for addressing the distress and failure of financial institutions in a way that maintains financial system stability, protects depositors, minimises fiscal risks, and maintains appropriate market discipline. Recovery and resolution planning by

⁴ APRA, *APRA Insight*, Issue 3, 2013.

⁵ Approximately \$40 billion General Insurance GWP and \$39 billion Life insurance premium income (comprising \$17.5 billion non-investment linked (effectively insurance related) and \$21.5 billion investment linked business).

⁶ KPMG Netherlands, *The Cumulative Impact of Regulation*, September 2012.

banks, and potentially other types of financial institutions, form an important element of such a framework. This is especially so where the financial institution in question is considered to be systemically important.

Internationally, the development of a policy framework on recovery and resolution planning has been led by the FSB and has focused on global systemically important banks. KPMG notes the G-20 Brisbane summit is expected to consider proposals from the FSB on the adequacy of global systemically important banks' loss absorbing capacity when they fail. Against this background, we suggest that the FSI frame its recommendations on resolution-related matters having regard to the FSB's and Basel Committee's current thinking on resolution policy, and in anticipation of any recommendations that may emerge from the G-20 Summit.

While the FSB focus is on global systemically important banks, many national regulators have been progressing with the implementation of resolution planning requirements for domestically important banks in their jurisdictions. For example, the European Parliament adopted the Bank Recovery and Resolution Directive in April 2014 and the Prudential Regulation Authority of the United Kingdom released policy and supervisory statements on resolution planning (in addition to those for recovery planning) in December 2013. The requirements of national authorities have been applied to domestic systemically important banks, as defined by them, and to other financial institutions which these authorities consider to be systemically important. These national regulatory responses have been informed by the FSB's previously published *Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes)*⁷.

In Australia, limited progress has been made on resolution planning. APRA has required large and medium sized banks to prepare and maintain recovery plans, but no resolution planning requirements have yet been released by APRA, aside from in the limited context of the FCS (with the requirements contained in Prudential Standard APS 910). This reflects APRA's stated preference – with which KPMG agrees – that recovery planning should precede resolution planning, in recognition that recovery planning deals with higher probability scenarios than does resolution planning and that recovery planning should form a key element in any financial institution's risk management framework. In contrast, resolution planning deals with low probability events in which a financial institution's recovery without external assistance is not feasible. The deferral of initiatives on resolution planning in Australia also recognises that resolution planning raises particularly challenging issues and potentially high compliance and efficiency costs, as regulators globally have discovered.

One option might be for the FSI to recommend that the Treasurer request the CoFR to undertake an analysis of the objectives, scope, options, and costs and benefits for different forms of resolution planning, with a view to reporting to the Treasurer on its findings. The report could be made subsequently public and opened up for consultation with the financial sector industry and other stakeholders. This may be a suitable first step before any resolution planning requirements are formulated. It could be usefully incorporated into a wider review by the CoFR, commissioned by the Treasurer, of potential options to address the too big to fail issue.

Strengthening resolution powers

Another important element of a robust framework for recovery and resolution planning is a dedicated resolution authority, equipped with the statutory powers and resources to resolve financial institutions in distress - flexibly, cost-effectively and in a timely manner. In 2012, Treasury consulted on a set of proposals for strengthening the resolution powers available to APRA, Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA). KPMG sees merit in reviewing the proposals, with a view to them being progressed through Parliament, subject to comprehensive cost/benefit analysis and further consultation with stakeholders. In particular, KPMG consider it is appropriate that APRA, as the resolution authority for ADIs and insurers, has the full suite of resolution powers needed for cost-effective resolution, consistent with the provisions set out in the FSB's *Key Attributes*.⁸ Similarly, it is important that ASIC and RBA are equipped with the necessary resolution powers to respond to financial distress in financial market infrastructure providers.

⁷ FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October 2011

⁸ *Ibid.*

Bail-in

One of the issues raised by the Interim Report is the so-called ‘bail-in’ resolution option – i.e. the ability to convert debt to capital or write-off debt to facilitate an ‘open resolution’ of a bank, thereby reducing the need for taxpayer-funded bail-outs. The bail-in tool is one possible component of potential resolution powers that could provide an alternative to using taxpayer funds to facilitate the resolution of a bank or other financial institution considered too large or complex to close down and liquidate. Bail-in has the potential not only to minimise the need for taxpayer-funded support, but to assist in strengthening market disciplines on the banking industry and thereby strengthen the incentives for sound risk management.

However, bail-in also carries considerable risks and costs. These include higher funding costs to banks, and therefore higher intermediation costs passed on to bank customers. Bail-in also creates a risk of contagion in a period of system stress, given the potential for it to trigger or exacerbate market uncertainty and liquidity pressures on banks in anticipation of some form of bail-in being applied. The implementation of bail-in also entails considerable regulatory and legal complexity, together with associated administration and compliance costs. Accordingly, bail-in as a resolution option needs to be carefully considered.

One option the FSI could consider is to recommend that the Treasurer request the CoFR to undertake a comprehensive assessment of bail-in options, as part of a wider assessment of the options for addressing the too big to fail issue, and to report its findings and recommendations to the Treasurer. The report could then be publicly released, with a view to consultation with industry and other stakeholders on the options available and the respective costs and benefits of each. More detailed discussion of bail-in liabilities within a resolution framework can be found in the KPMG publication: *Bail in Liabilities: Practical Implications*⁹.

Capital requirements for systemically important financial institutions

An issue raised by the FSI is whether capital requirements should be strengthened for systemically important financial institutions. This is an issue that has attracted considerable attention internationally in the context of measures to reduce too big to fail. Capital regulation seeks to promote the safety and soundness of individual financial institutions and the deliverability of their ‘promise to pay’, and in so doing seeks to enhance system-wide stability.

In this respect, the Basel capital adequacy framework comprises a number of overlapping capital requirements, rather than a set of common minimum capital requirements with a single adjustment factor in instances of an institution being designated as systemically important. In considering the sufficiency of capital adequacy requirements, we would also note the significant changes to the requirements for the identification and calculation of risk-weighted assets against which minimum capital requirements are assigned. APRA regulatory requirements also include a number of national discretions which impact reported capital ratios compared with other regulatory regimes. For example, there is the formal inclusion of IRRBB within Pillar 1 risk-weighted asset calculations of accredited banks that are deemed advanced.

The large banks in Australia are already subject to a Basel III-compliant capital regime administered by APRA and are among the highest credit-rated banks in the world. Any proposal to impose higher capital requirements on these banks therefore needs to be considered with appropriate caution, taking into account the existing relatively strong capital position of the banks. Any consideration of higher capital requirements for systemically important banks should take into account a number of additional factors, including:

- the results of APRA’s stress testing, (in terms of the resilience of banks to a plausible, but severe, range of economic shocks);
- the costs and efficiency implications associated with any increase in capital requirements, including the ability of banks to meet the needs of the real economy;
- the costs and benefits of alternative prudential tools to manage risks in the financial system, including the intended review of large exposure limits and the introduction of the new risk management requirements by APRA under Prudential Standard CPS 220;

⁹ <http://www.kpmg.com/BE/en/IssuesAndInsights/ArticlesPublications/Documents/bail-in-debt-practical-implications.pdf>

- the costs and benefits of alternative options for reducing too big to fail, including resolution planning, separation or separability of systemically important functions, bail-in and industry-funded resolution funding arrangements.

Viewed in this context, capital is just one option among several for promoting greater financial system stability and reducing too big to fail.

Risk weightings under the Basel capital framework

Under the current Basel capital arrangements applied by APRA, small ADIs, including mutuals, are disadvantaged by not being able to apply the lower risk weights on certain asset categories that the large ADIs with approved internal models can apply. This is especially significant in regard to residential lending, where small ADIs are placed at a competitive disadvantage relative to large ADIs. KPMG suggests that this issue be assessed, with a view to exploring the scope for a concessional risk weight being available for low-risk lending (such as residential lending), similar in nature to that available under an internal model framework, provided that an ADI satisfies specified requirements in relation to their risk management policies and practices (for example, as regards conservative lending criteria, loan review and portfolio diversification).

The Basel Committee, in its adoption of the now standardised approach to the calculation of credit risk, determined that lending which is fully secured by mortgages on residential property (both owner-occupied or rented) could be risk-weighted at 35 percent. It considered this weighting to be concessionary and accordingly was to be “applied restrictively for residential purposes and in accordance with strict prudential criteria”. National supervisory authorities were expected to evaluate whether this risk weight was too low based on the default experience for these types of exposures in their jurisdictions.

APRA’s risk weighting requirements for residential mortgages are expressed in APS 112, Attachment D and include a minimum risk weighting of 35 percent. Its requirements are also scaled upwards from this minimum requirement, depending on differences in loan-to-valuation outcomes, the nature of the mortgage lending agreement and the existence of loan mortgage insurance, among various other identified factors. APRA has also applied additional risk weighting requirements for reverse mortgages and mortgage loans to self-managed superannuation funds. Accordingly, a tiered system of standardised risk weights does operate for residential mortgage lending as part of the Australian regulatory framework.

As a matter of principle, KPMG supports the implementation of the Basel Framework by national regulators in a manner that involves limited additional application of national discretions. This has been APRA’s approach to the standardised risk weights applied to residential mortgage lending. However, it has not been APRA’s approach to the calculation of credit risk under the advanced or internal ratings based (IRB) approach to the calculation of credit risk weighted assets. In particular, APRA has imposed ‘nexus’ requirements for the development and accreditation of advanced capabilities for the calculation of credit risk, operational risk and IRRBB (refer APS 113, paragraphs 26 and 27). APRA also appears to have accepted only limited use of possible transitional arrangements in the implementation of the IRB approach to credit risk measurement across the asset classes, separately identified in the IRB approach, and which are significant to an ADI’s own particular balance sheet. APRA’s requirements for advanced accreditation can accordingly be viewed as being subject to a high degree of national discretion.

KPMG considers that it should be permissible for banks to seek IRB credit risk accreditation for certain asset classes on a transitional basis and to do so without also being subject to additional nexus requirements. It should be permissible for ADIs to implement such an approach starting with their residential mortgage portfolios.

Financial Claims Scheme

The FCS is an integral part of addressing the policy objectives of financial stability and an essential element in Australia’s resolution framework. In substance, the FCS is a deposit insurance scheme. It serves the same purpose as other deposit insurance schemes globally – to provide retail depositors with an assurance that they will not sustain losses on, and will have prompt access to, their deposits in banks up to a defined cap. The current FCS arrangements substantially deliver on these objectives.

An issue that has been raised in the Interim Report is whether the FCS should become a pre-funded scheme. Although post-funded schemes are becoming the exception internationally, with most countries having established pre-funded deposit insurance arrangements, a post-funded scheme is a viable option, provided

that the funding is available immediately upon the triggering of the scheme (i.e. on the decision to close an ADI and commence pay-out or deposit account transfer). The current ex post funding arrangements facilitate immediate access to funding, given the standing appropriation of up to \$20 billion per ADI.

In addition, KPMG notes that a pre-funded scheme clearly entails costs that a post-funded scheme does not, including the costs to ADIs of regular contributions, the opportunity cost associated with these funds no longer being in the banking system, and the costs of administering the FCS fund. None of these costs arise with the existing FCS. These factors therefore need to be weighed against potential benefits associated with a pre-funded scheme.

One potential advantage of a pre-funded scheme is that pre-funding would better meet the principle of 'user pays' than post-funding, given that all ADIs with FCS protected deposits would pay into the scheme. In contrast, under the existing arrangements, a failed ADI has made no contribution to funding of the scheme; any shortfall in recoveries from the failed ADI's balance sheet upon liquidation would be met by other ADIs. This does not accord with a user pays approach. That said, a pre-funded scheme is only likely to meet the user pays principle if the premiums are risk-based, as opposed to a uniform fee.

Any consideration of moving the FCS to a pre-funded scheme should include consideration of whether the fund could be used for wider resolution purposes (e.g. various forms of open resolution), as is commonly the case in many countries with pre-funded deposit insurance schemes.

Other issues that may warrant consideration in the context of the FCS include:

- The assessment of options to reduce compliance costs for ADIs associated with the requirements of APS 910. In particular, KPMG sees merit in APRA working more closely with the industry to address remaining issues of interpretation of APS 910 where ambiguities have arisen and exploring the options for lowering compliance costs associated with the Single Customer View requirement and the requirement to develop, maintain and periodically test an IT facility enabling depositors to upload details of their alternative bank accounts where they have them. The latter is an expensive requirement if it is to be effective, particularly given the very low probability scenario in which it would be relevant.
- The development of a more rapid and effective pay-out mechanism than the cheque and EFT options developed by APRA. Neither option will provide an assured means of prompt pay-out. Payment by cheque will become an out-of-date technology in the not too distant future and is prone to fraud and theft, as well as delays in processing. Electronic Funds Transfer (EFT) is reliant on account-holders having alternative transaction deposit accounts in more than one ADI, which many depositors do not have. An option that should be considered by APRA is the use of FCS funding to fund the transfer of FCS-protected transaction accounts and associated functionality to another ADI or bridge entity, up to the eligible limit. This would provide a much faster and secure means of giving account-holders access to their funds. We note that deposit account transfer (as opposed to paying out depositors) is the preferred approach for many deposit insurance schemes globally, including the United States, in recognition of its speed, security and convenience for depositors.

Ring fencing

The financial accounts and Pillar 3 disclosures of Australian banks show that their current business models involve limited investment and proprietary trading. In other jurisdictions, the extent of these activities has often been the basis for proposals or decisions regarding ring-fencing such activities from traditional banking or curtailing their permissibility as a business activity.

We would also note that the reforms of the Basel III regulatory framework have partially addressed this issue. They have extended to the modification of risk calculations, particularly for traded-market risk and counterparty credit risk, the introduction of short-term liquidity requirements, various financial markets infrastructure requirements (including the preferred/required manner in which derivative transactions are transacted) and increased focus on the identification of critical functions within banking institutions.

The regulatory framework as it applies to Australian banks has also considered the totality of their business activities and the risks of reputational/contagion damage arising from activities outside direct regulatory supervision. This will be reinforced by APRA's proposed formalisation of a conglomerates policy framework that will, if implemented, impose various requirements relating to risk governance, capital adequacy, risk exposure limits and liquidity management across the conglomerate group. Importantly, they also include

specific measures relating to intra-group contagion and the measurement and management of large exposures on a whole-of-group basis.

In KPMG's assessment, the adoption of conglomerate regulatory and supervisory requirements significantly reduces the need for ring-fencing. Moreover, we would have concerns at the potential efficiency costs associated with ring-fencing, the arbitrariness of separation boundaries and the risk of some activities moving into 'shadow banking' and outside of the regulatory framework.

We would also suggest that imposing requirements for structural separation may require reconsideration of the current acceptance of branch banking arrangements. If consideration is given to the separation of proprietary/investment activity from client business, this should be undertaken in the wider context of too big to fail and should be subject to thorough cost/benefit assessment.

Stress testing

As previously noted, stress testing is an integral component of the Australian regulatory framework and of APRA's prudential capital requirements for individual, regulated institutions. Prudential standard CPS 220 requires stress testing and forward-looking scenario analysis to form part of an APRA-regulated institution's risk management framework.

The effectiveness of stress testing practices has also been enhanced by the permissible implementation of tri-partite reviews as determined by APRA under APS 310. In recent years, such reviews have looked at various policy settings and processes of banks. This has included their residential mortgage books and involved file reviews as considered necessary.

KPMG sees stress testing as an important tool to inform the adequacy of risk management and capital settings across banks and other financial institutions. We therefore support APRA's initiatives in this area. However, as with other prudential policies, there is a need for consideration of the compliance burdens associated with stress testing requirements and for APRA to factor these costs into its requirements in this area.

Corporate governance

KPMG recognises the critical importance of corporate governance to financial institution soundness and financial system stability. It is the cornerstone of prudent risk management. Equally, sound governance provides the foundation for the adoption of financial institution strategies that lead to financial innovation and a more efficient, dynamic financial system. We therefore endorse the importance that has been placed on corporate governance by APRA and ASIC, among others, as part of the overall regulatory framework.

Recent moves by APRA to reinforce the expectation that boards of financial institutions should take ultimate responsibility for risk management in their financial institution needs to be seen in this context. While KPMG sees merit in affirming the role of the board in relation to risk management, it is essential that there is a clearly understood and articulated delineation between the role and responsibilities of the board (and board committees) and the role and responsibilities of management, where boards focus on overseeing the performance of management rather than being responsible for the day-to-day management of a financial institution. In that context, we see merit in APRA reviewing its prudential standards with a view to ensuring there is no ambiguity here. This includes greater clarity around the expectations of the role of the board of financial institutions in relation to risk management and prudential matters and visibly maintaining the delineation between the role of the board and the role of management.

APRA has stated it is developing an information pamphlet for new and existing board members to give a concise and plain-English view of what APRA expects of board members in their oversight of prudential matters. It has further stated its intention to perform a stock take of its existing requirements for boards to assess consistency across industries and whether any requirements are "unreasonable or unduly onerous". These developments, while welcome, clearly indicate the benefits to be achieved from regular and more formalised engagement between APRA and relevant industry groups.

Under-insurance

The Interim Report welcomes further evidence and data in relation to the issue of under-insurance. KPMG has recently undertaken two research projects¹⁰ to measure the level of underinsurance in Australia¹¹: firstly, in respect of insurance against premature death and, secondly, in relation to disability. The research found that the level of underinsurance of the lives of employed people in Australian families was an estimated \$800 billion in respect of insurance against premature death. The level of underinsurance of employed people in Australian families in the event of disability was estimated to be \$304 billion per annum.

Insurance against premature death

The typical person with dependent children and a partner requires insurance of \$570,000 in the event of death. Our analysis of the population and the insured coverage suggests that 19 percent of families do not have any death insurance. Underinsurance levels vary significantly by age group, gender and geographical location. Australians in the age group of 18 to 29 year olds are the most underinsured for death (48 percent underinsured). The cost of underinsurance is significant to Australia. If Australians were adequately insured, social security benefits could be reduced by \$29 million after taking foregone tax revenue into account.

Disability

The typical employed person requires insurance of 84 percent of income until retirement age in the event of disability. Our analysis of the population suggests that 35 percent of people do not have any disability insurance. Underinsurance levels vary significantly by age group, gender and geographical location. Australians in the age group of 45 to 64 year olds are the most underinsured (77 percent underinsured). If Australians were adequately insured, social security benefits could be reduced by a minimum of \$340 million in the first year, even before the impact of foregone tax revenue is taken into account. After 10 years, this saving could rise to an estimated \$2.5 billion, based on the current level of means testing of the pension.

¹⁰ KPMG, *Underinsurance: Death Protection Gap in Australia*, July 2013 and KPMG, *Underinsurance: Disability Protection Gap in Australia*, January 2014. The FSC engaged KPMG to conduct an investigation into the level of underinsurance of Australian lives.

¹¹ Underinsurance is measured against an adequate level of insurance designed to cover basic needs such as outstanding mortgage balances, as well as ensuring that standards of living are broadly unchanged following the death or disability of an income earner.

Superannuation and Wealth Management

Superannuation

Fees and costs in the superannuation sector – competition and member engagement

This section of KPMG's supplementary submission comments on the Interim Report's observation that "there is little evidence of strong fee-based competition in the super sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the super sector".¹²

KPMG believes there are opportunities to continue improving operational efficiency within the Australian superannuation system by capitalising on existing regulatory changes and encouraging greater competition and engagement within the sector.

The industry has, and will continue, to undergo significant change as a result of a number of regulatory reforms, many of which, like SuperStream, will improve operational efficiency by enhancing and modernising the back office of superannuation. The benefit of these reforms will be realised in the future following implementation of the changes. This is acknowledged by the Inquiry, which notes that it is "too early to assess whether [the] reforms will achieve their objectives".¹³

While these regulatory changes will help to drive operational efficiency within the sector, we believe that increased competition and member engagement will contribute to improved efficiency. Consequently, we encourage the Inquiry to examine and suggest ways to improve competition and member engagement, as this will assist in enhancing efficiency by driving down operating costs and member fees.

One of the initiatives being considered by a number of participants to improve efficiency is the internalisation of investment management activities once they reach a sufficient size and scale. Funds indicate that reducing investment costs associated with investment manager fees, including performance-based fees, is a key driver in establishing in-house investment teams. The Rotman International Journal of Pension Management indicates that "funds with more internal management performed better than funds with less".¹⁴ Rotman found that for every 10 percent increase in funds managed internally, there was an increase of 3.6 basis points in net value added, "driven largely by the lower costs attributed to internal management".¹⁵ We believe the development of these in-house operations will assist in improving efficiency, providing they are supported by appropriate investment governance and operational frameworks. These frameworks should allow the Trustee and management to monitor and manage the performance, risk and efficiency of these in-house investment operations.

Increasing competition in the sector will also help to enhance efficiency. One way this can be achieved is through the publication of regular and meaningful industry statistics on costs and performance. A publication from the Institute of Public Affairs of Australia on transparency in superannuation found that "inadequate disclosure is the main reason that Australians are disengaged".¹⁶ APRA collects a significant amount of data on fund performance and efficiency through the revised APRA Reporting Forms and the MySuper dashboard that Fund's are required to disclose publicly on their website. However, it is also important that this information is easy to understand. KPMG notes that an exercise conducted by Chant West which involved comparing the information disclosed in Product Disclosure Statements (PDSs) of the 30 largest industry and 30 largest retail funds required Chant West to make 146 adjustments for the information from all the funds comparable.¹⁷ Consequently, we encourage the Inquiry to examine ways to enhance transparency in the sector by requiring the regulator to develop and release regular and comparable information on fund performance and efficiency to drive member engagement and competition in the sector.

¹² Financial System Inquiry, *Interim Report*, July 2014, p.2-99.

¹³ *Ibid.*, p.2-106.

¹⁴ 'How Large Pension Funds Organize Themselves: Findings from a Unique 19-Fund Survey', *Rotman International Journal of Pension Management*, Vol. 5, No 1, p. 34, 2012

¹⁵ *Ibid.*

¹⁶ www.ipa.org.au/library/publication/1271304263_document_keeping_super_safe_final_-_ipa_small_.pdf

¹⁷ 'Outcomes Transparency', *Super System Review Final Report*, Chapter 4, p.107, at www.supersystemreview.gov.au.

Having accurate and regular information on fund performance and efficiency is particularly important given the focus on scale within the sector. While scale is not a defined number, it is the ability to operate the fund efficiently when compared to similar funds based on the number of members and assets under management. Trustees of MySuper products must attest on an annual basis that the fund has sufficient assets and members are not disadvantaged compared to other funds.¹⁸ It is important therefore to have comparable data on fund performance and efficiency regularly available to enable informed decisions to be made. This information will enable Trustees of funds to make comparisons between their fund and others to identify opportunities to optimise operations to improve operational efficiency and economies of scale.

We believe that member engagement can also help to improve competition within the sector. Engagement does not imply that members must know their account balance for any given year. Improving engagement is about enhancing members' awareness and experience while in the sector. Being more aware increases the likelihood of a person having sufficient superannuation savings for a comfortable retirement, thereby reducing reliance on the age pension. Innovation within the sector can assist in developing new product and service suites for accumulation and retired members to improve members' experience and engagement. We have detailed below a few initiatives that can improve engagement with super members, which we believe the Inquiry can examine and promote:

- *Publish projections on future super balances and lifestyles* to raise member engagement and understanding of superannuation. These projections should include considerations of the impact of different return and risk targets (portfolio options) for the member in both accumulation and retirement. We note that some funds within the industry are already incorporating projections on member statements. Additionally, the projections should enable members to take into consideration their anticipated or desired future expenses. These projections should be compared to the lifestyle of members if relying on the age pension. This approach was used by a financial group in the United States to increase member participation with 401(k) plans by 80 percent in just two years. It did this by demonstrating that relying on social security benefits does not allow members to enjoy a comfortable retirement in the United States.¹⁹ The Inquiry should examine the use of projections to improve member engagement and understanding.
- *Make superannuation easier to understand.* The Inquiry should examine opportunities to reduce complexity within the sector, including, as detailed above, the use of simple and understandable projections and development of publications that explain what super is, how the system operates, and the basic rules. Complexity within the system results in apathy and confusion among members. The Super System Review found that "the average number of investment options offered by 121 retail funds was 165".²⁰ However, research from the United Kingdom's Turner Commission Report found that any more than six or seven investment options made people disengage.²¹

¹⁸ *Superannuation (Industry) Supervision Act*, s. 29VN(b).

¹⁹ www.post-gazette.com/pg/06270/725459-28.stm.

²⁰ Cooper Review, *Final Report*, Part Two, 5 July, 2010, p. 106.

²¹ <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=transcripts/2008/007.htm&pageID=004&min=njs&Year=2008&DocType=2>

Leverage

The Interim Report observes that direct leverage may create vulnerabilities in the superannuation and financial systems. However, in considering restoring the general prohibition on direct leverage it is important to consider the specific risks to be managed and alternative mitigants:

- if the risk is that Self-managed Super Funds (SMSFs) are being established inappropriately in order to facilitate a gearing strategy, this risk could be managed in a more targeted way by continuing to focus on advice-quality requirements to ensure that any recommendation to establish an SMSF is both in the best interests of the client and is appropriate under existing law;
- if the risk is that SMSFs are borrowing to purchase poor quality assets, additional guidance could be provided by APRA as to the assessment and treatment of these credit risks by lenders; and
- if the risk is that SMSFs are taking out loans they cannot afford to service, the FSI could consider expanding responsible lending obligations and other protections under the Australian Credit Law to the sale of Limited Recourse Borrowing Arrangements (LRBAs) to SMSFs.

Issues associated with SMSF leverage can be overcome or mitigated through effective financial advice, clear and concise guidance materials, and through a robust annual audit. We question whether a ban or limitation on leverage within SMSFs is appropriate. Consequently we encourage the Inquiry to examine the quality of financial advice provided when establishing an SMSF and the ongoing auditor responsibilities, which can assess whether the SMSF has been setup correctly and complies with the pertinent SIS Act and regulations. Additionally, we encourage the Inquiry to examine the information provided by the regulator to new SMSFs, especially information on leverage and gearing within the SMSF. The development of clear and concise guidance materials may mitigate the risk associated with leverage within SMSFs.

While we note that Government is reviewing and enhancing the quality of financial advice through the Future of Financial Advice reforms, the quality of advice provided to SMSFs needs to be specifically reviewed and improved to protect SMSFs from any potential unscrupulous behaviour. We believe that quality financial advice can help educate the Trustee on the complexity and risks associated with establishing an SMSF, including risks associated with leverage.

We note that changes have been made to the SMSF auditor registration process to enhance audit quality. These changes include requiring auditors applying to be an SMSF auditor to have sufficient experience based on hours of SMSF audit experience and annual education requirements.²² While these represent positive steps, we believe that auditor registration requirements can be strengthened to further enhance the SMSF audit quality, fulfilling the gate keeper role within the SMSF sector.

Furthermore, while we believe that the ATO is performing well as the regulator of SMSFs, we believe its role could be enhanced with additional resources and funding. Given the size of the SMSF sector and the importance in ensuring that it is properly regulated, we also encourage the Inquiry to consider mechanisms to improve the ATO's funding. However, this should entail clear accountability for the funds to ensure it is effectively used for regulating SMSFs.

²² ASIC, 'Registration of Self-Managed Superannuation Fund Auditors', *Regulatory Guide 243*, January 2013.

Consumer Outcomes

Independence

It is unlikely many consumers understand the criteria for using the restricted words “independent, impartial and unbiased”²³ or what that indicates about the way the adviser is remunerated and the adviser’s relationship with product issuers. However, it is equally unlikely consumer understanding of independence and the management of conflicts of interest will be improved by more clearly distinguishing between independent and aligned advisers.

The Retail Distribution Review (RDR) Post Implementation Review²⁴ published consumer survey results indicating that a large proportion of survey respondents could not say whether their adviser was independent or what effect that had on the adviser’s ability to recommend a range of products or only those from a single company. More important is the ongoing focus on adequate management of conflicts of interest – either under the general obligation for Australian Financial Services (AFS) Licensees or more specifically under the best interests duty²⁵ and conflicts priority rule.²⁶ These obligations should apply equally to independent and aligned advisers.

²³ S.923A, *Corporations Act* (Cth), 2001.

²⁴ Financial Services Authority, *RDR Post Implementation Review*, November 2001 at www.fsa.gov.uk/pubs/RDR-baseline-measures.pdf.

²⁵ S.961B, *Corporations Act* (Cth), 2001.

²⁶ S.961J, *Corporations Act* (Cth), 2001.

Addressing emerging technology risks

The Commonwealth Attorney General's Department operates a closed public/private forum, the Trusted Information Sharing Network (TISN).²⁷ This contains various industry sector groups including a Banking and Finance Sector Group (BFSG). The BFSG involves regulators and participants from across the financial services sector and enables a forum for discussion on a range of issues, and in particular, cyber security.

Also at the umbrella TISN level, the capability exists for cross-sector collaboration such as might occur between the BFSG and the Telecommunications Sector Group. These clearly have related challenges in the area of cyber security. TISN also operates an IT Security Expert Advisory Group (ITSEAG) which provides support to the sector groups. A recent initiative of the BFSG is the launching of a project to operate an industry-wide crisis simulation.

KPMG believe that the TISN and the BFSG provide a vital service in strengthening cyber security in financial services. In comparison, the United States' Financial Services Information Sharing and Analysis Center (FS-ISAC) is arguably more open in its participation numbers due to the different nature of the financial services industry in the United States and the number of financial services organisations. There might be a risk in broadening the BFSG participants here as, in our experience, private sector organisations are less likely to be candid in sharing their cyber security experiences to a broad or more open audience. There might, however, be opportunities to adopt some of the FS-ISAC initiatives, such as anonymous information sharing.

The TISN and the BFSG should continue to be supported by Government and the financial services industry as the most appropriate vehicle for private/public sector discussion on strategic issues including cyber crisis planning, frameworks and cyber security policy.

²⁷ See www.tisn.gov.au.

Addressing a range of taxation matters

Taxation

KPMG respects the overall approach taken to tax issues in the Interim Report, but is concerned we may lose an opportunity for change. It correctly identifies a number of taxes that affect the allocation of funding and risk in the economy. However, the approach foreshadowed by the Report – to defer consideration of all of the taxation issues (with the exception of Venture Capital Limited Partnerships) to the Tax White Paper process – misses an opportunity to provide the Government with guidance on financial system specific tax issues.

The tax observations made by the Interim Report can be placed into two distinct categories. The first are those that have an impact broader than the financial system itself. These include, a number of the tax settings that affect household savings, including negative gearing, imputation and the tax concessions embedded in the superannuation system. We agree that consideration of these issues needs to take place in the context of a broader taxation policy debate that is foreshadowed to occur through the Tax White Paper process.

Financial system tax issues

The second category is those tax considerations that are specifically relevant to the financial system. The majority of these issues have been the subject of previous reviews (the 2009 Johnson Report and, more recently, by the Board of Tax). The implementation of the recommendations of these previous reviews has been slow or (in the case of some measures) is not proceeding. In this context, there is the risk that the deferral of these matters to the Tax White Paper process will result in them being relegated to second order in the broader macro-policy issues that will be the focus of the White Paper. As a result, action on these matters will be deferred indefinitely.

Tax settings impact funding options

The Interim Report highlights the significant challenges to bank funding as a result of Basel III. In relation to liquidity, these include the liquidity coverage ratio and the proposed net stable funding ratio. Bank deposits provide the lowest after-tax rate of return of household savings options. Longer terms household investments are drawn towards superannuation and capital assets, the income and gains of which are concessionally taxed. The Inquiry should consider whether tax breaks for returns on longer term deposits would enhance banks' access to longer term stable funding in Australia. The current London Inter-bank Offered Rate (LIBOR) cap rules also operate adversely in respect of floating rate term funding.

Withholding taxes

KPMG encourages this Inquiry to examine the benefits of interest withholding tax reform and putting the case to Government of the broader benefits to the economy of less distortion of cross-border funding for financial institutions. The modern tax treaty regime provides financial institutions with bilateral interest withholding tax exemptions in a number of important jurisdictions. Further pairing back of withholding tax will increase competition and reduce the cost of funding. The abolition of the LIBOR cap will remove a tax distortion regarding the funding of foreign bank branches.

As tax issues relevant only to the financial sector, this Inquiry should leverage the work done previously by Johnson and the Board of Tax, keep these issues at the forefront of the agenda, and provide clear recommendations to Government. Interest withholding tax reform for financial institutions and the LIBOR Cap will be lost in a white paper process that will inevitably focus on more politically charged issues such as the Goods and Services Tax (GST) rate and base debate, imputation, negative gearing and superannuation reform.

Islamic finance

The Inquiry should also form a view in relation to the Islamic finance reforms. These were the subject of recommendations from the Johnson Report and a subsequent report from the Board of Tax delivered to Government in 2012. The inertia exhibited as regards reforms to provide Islamic finance products with parity of treatment, continues to exclude Australia from accessing a significant source of funds in the Middle East and South East Asia.

Venture Capital Limited Partnerships

As with a number of more recently enacted tax regimes (for example the Taxation of Financial Arrangements rules) the drafting of these provisions has been overly focused on integrity, rather than providing a regime that can adapt and respond to developments in these investments. We recommend that flexibility is an integral part of the recasting of the Venture Capital Limited Partnership rules.

Appendix

First Submission

A copy of KPMG's first submission, *Financial System Inquiry: KPMG Submission March 31, 2014* can be found at KPMG Australia's website (www.kpmg.com.au):

<http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Documents/financial-system-inquiry-kpmg-submission-31-march-2014.pdf>

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September 2014