Westpac GROUP
EST. 1817

INITIAL SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

A financial system to best support Australia's growth

Westpac Banking Corporation

March 2014

Westpac st.george BankSA BT Financial Group Bank of Melbourne RAMS

SNAPSHOT OF THE DOCUMENT

OVERVIEW	
Executive Summary	
SECTION 1: THE LANDSCAPE	
Chapter 1: The Financial System since the Wallis Inquiry	The importance of the financial system and a history of the instrumental role the system, and the Westpac Group particularly, have played in supporting Australia. Explains the principles that should be applied in assessing the system and any enhancements.
Chapter 2: Serving Customer Needs Through Competition	How the financial system meets customer needs through competition, with a focus on financial intermediation and mortgage lending.
Chapter 3: Regulatory Reform and its Consequences	The current regulatory landscape following the GFC, its cumulative effects, and opportunities for more efficient implementation of regulation.
SECTION 2: CHALLENGES AND OPPORTUNITIES FOR THE AUSTRALIAN FINANCIAL SYSTEM	
Chapter 4: Funding Australia's Financial System for Economic Growth	The funding of the financial system to best support Australia's economic growth.
Chapter 5: Enhancing Australia's Productive Capacity: Supporting SMEs	The financial system's support of the small and medium enterprise sector.
Chapter 6: Building and Protecting Australia's Wealth	The growth of the superannuation sector, its importance to the financial system, and pertinent issues regarding advice, insurance and the export of financial services.
Chapter 7: Developments in Technology and Payments	The challenges and opportunities associated with the development of technology in the financial system, including regulatory implications.
Conclusion	

TABLE OF CONTENTS

EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

The setting of the Inquiry

The Government's Financial System Inquiry (Inquiry) is an important and timely step towards cementing Australia's long-term economic growth and prosperity. The Westpac Group (Westpac) welcomes the opportunity to contribute towards the Inquiry and its goals.

The financial system is diverse, strong and highly effective in meeting the needs of customers and the economy. According to the International Monetary Fund (IMF):

"Australia's financial system is sound, resilient, and well-managed. Major banks are conservatively run, well capitalised and profitable, and they are likely to withstand severe shocks."[1]

There are many indicators of the strong performance of our financial system, including:

- Efficiency – for example, major banks' net interest margins have declined by around a third, or one percentage point, in the 17 years since the Wallis Inquiry;
- Resilience – demonstrated by the system's support of Australia's economy through the Global Financial Crisis (GFC), and Australia remaining one of the few developed nations in the world to avoid a systemic banking crisis in recent history;
- Inclusiveness – Australians have among the world's highest rates of financial system participation; and
- The growth of Australia's superannuation system – Australia now has the fourth largest pension market in the world, and the superannuation system is ranked equal second globally on adequacy, sustainability and integrity measures.[2]

The strength of the financial system has supported the sustained period of economic growth experienced in Australia. Evidence shows that economic growth between 1977 and 2009 was supported by average credit growth between 1.5 to 1.7 times the growth in nominal GDP.[3]

A blueprint for the future of the financial system

There have been, and will remain, important ongoing changes affecting the financial system such as:

- Global and domestic regulatory reform following the GFC, particularly impacting the funding of the system;
- Demographic change in Australia, particularly ageing;
- The growth of the superannuation sector; and
- Developments in technology that profoundly change the customer experience.

It is now propitious to examine these changes to ensure Australia's already strong financial system continues to support the economic and social growth of the nation. The Inquiry presents an opportunity to create a blueprint to achieve this goal.

In developing this blueprint, Westpac believes six specific areas are worthy of the Inquiry's focus:

- Competition in the system;
- Regulation of the system;
- Funding of the system;
- The system's support of small and medium enterprises (SMEs);
- Building and protecting the wealth of Australians; and
- The application of technology in financial services.

1. http://www.apra.gov.au/AboutAPRA/Publications/Documents/cr12308[1].pdf, at p.1.
2. Melbourne Mercer Global Pensions Index 2013.
3. PricewaterhouseCoopers (PwC) analysis. Discussed further in Chapter 4.

These elements of the financial system are pivotal to Australia's growth because:

- The better the system's ability to meet the needs of customers, the greater the level of economic activity of the nation; and
- Enabling more efficient, innovative and convenient ways for customers to access financial services drives greater productivity within the system and the economy as a whole.

Westpac's submission dedicates a chapter to each of the six elements noted above.

Competition in the system

Australia's financial system is dynamic, diverse and competitive, with a range of participants and offerings for customers ranging from banks to non-banks, exchanges, managed funds, insurers, international investors and payments providers. Choice is prevalent throughout the system.

This submission focuses on competition in the context of two components of the system vital to the financing needs of many Australians and businesses:

- The sources of financial intermediation – provided by both banks and markets; and
- Competition in retail banking services, particularly mortgage lending.

Banks play an important, but not dominant, role in the provision of credit to Australian individuals, businesses and institutions. Markets (debt and equity) also play a significant role. Banks, however, do play a critical role in supporting the resilience of the financial system through economic cycles. In cyclical downturns, banks are better able to continue providing credit by drawing upon long-term relationships with customers. This was important for Australia during the GFC.

Retail banking in Australia reflects a high degree of competition, with a diversity of competitors with different strategies, sizes and focus. Within the retail banking sector, competition in mortgage lending remains the focus of much commentary. Given this, and its importance to the Australian economy, the competitive dynamics of mortgage lending are analysed in Westpac's submission.

Demand for property, supported through mortgage lending, has been a key driver of credit growth. Australia's banking system has facilitated credit growth competitively, efficiently and safely, which has provided important support for the sustained period of strong economic growth experienced in Australia.

Various characteristics of mortgage lending demonstrate its competitiveness. These include:

- Contestability – with current evidence demonstrating the ability of non-major bank mortgage lenders to win market share;
- The broad and extensive product choices available; and
- Pricing efficiency.

Regulation of the system

The financial system's regulatory framework is critical to the system's ability to meet the needs of customers, and to support the nation's growth. Efficient regulation is necessary for a well-functioning financial system.

Since the GFC, regulatory change has focused heavily on stability – in some cases at the expense of efficiency and growth. This has been driven primarily by the G20 global reform agenda.

There is the risk that these reforms may affect the lending and transactional capacity of Australia's financial system and its ability to invest for growth and productivity. For example, in the 2013 financial year, Westpac invested $302 million (or 26% of total investment spending) on regulatory change compliance, a significantly larger amount than before the GFC.

In Westpac's view, there is much to be gained by undertaking a stocktake of the agenda for regulatory reform to evaluate the combined impact of existing and proposed regulation. There are also opportunities to streamline the implementation of regulation by Australia's financial system regulators.

In the context of the implementation of the G20 reform program in Australia, Westpac believes there is a need for Australia's financial system regulators to take account of Australia's commitment to the G20 growth and financial system efficiency objectives in their domestic implementation of the global reform program.

Pertaining to the financial system's regulatory framework, Westpac **recommends**:

- The Inquiry undertakes a stocktake of the agenda for regulatory reform to evaluate the combined impact of existing and proposed regulation;
- Australia's financial system regulators take account of Australia's commitment to the G20 growth and financial system efficiency objectives in their domestic implementation of the global reform program; and
- The Inquiry considers ways of streamlining the implementation of regulation by financial system regulators.

Funding of the system

The quantity and quality of funding available to the financial system is vital for the system's ability to fund the economic activities of customers.

Bank intermediation is best placed to support a high and sustainable level of credit provision for Australian consumers and businesses, and hence economic growth. Banks provide vital credit provision functions such as credit, maturity and liquidity transformation. They do so within a robust regulatory and supervisory framework and by investing in credit assessment expertise over a long period.

Bank intermediation is most efficiently supplied from highest quality funding sources that maximise lending capacity. Optimising access to high quality funding sources is therefore critical to credit growth, and Australia's economic growth.

In the future, a 'funding gap' may emerge between the demand for credit and the banking system's ability to supply it. This could have the consequence of limiting Australia's growth.

It is therefore important for the Inquiry to consider options for increasing access to highest quality funding for bank intermediation. The primary long-term solutions for achieving this outcome are measures for tax equalisation between bank deposits and other competing savings options; and encouraging the investment of superannuation savings into bank deposits and fixed income securities.

Other options, such as support for the securitisation and corporate bond markets, would complement these measures and also support further competition in the financial system.

Westpac **recommends** the Inquiry:

- Considers measures for tax equalisation between bank deposits and other competing savings options; and
- Considers options to encourage superannuation savings into bank deposits and fixed income securities.

The system's support of SMEs

The financial system's support of the SME sector will be critical in supporting Australia's productive capacity and growth.

SMEs as a driver of innovation will become increasingly important in the development of Australia's 'knowledge economy'.

EXECUTIVE SUMMARY

Westpac provides both financial and non-financial support to ensure the start-up, expansion and growth of SMEs. This includes: transaction and payment services; the provision of advice; education and technology; risk management products; and debt finance.

There has been recent discussion on SMEs' ability to access external financing. Both debt and equity finance can provide an appropriate source of working or growth capital for SMEs.

Overall, the evidence suggests that debt finance is readily available for the SME sector. There are some measures that could support SMEs' access to debt finance further, such as increasing SMEs' capability to apply for finance and lenders' access to alternative types of information.

However, there is likely to remain a subset of SMEs where the provision of debt financing falls outside appropriate risk management or responsible lending criteria. In these cases, equity may be a more appropriate source of finance, particularly for innovative and start-up SMEs that are generally higher risk propositions for lenders. Greater capital from alternative sources could also improve the creditworthiness of SME customers, increasing their prospects of obtaining debt finance.

Westpac **recommends** the establishment of a taskforce comprising Government and industry representatives to examine:

- Alternative financing in Australia (such as private equity, start-up and growth funds, venture capital and emerging trends), including current barriers to market development and potential opportunities to enhance the financing mix available to SMEs; and
- Opportunities for other forms of non-financial support to be increased, including providing SMEs education to increase awareness of the range of financing options available and improved expertise to apply for external (debt and equity) finance.

Building and protecting the wealth of Australians

The current superannuation system operates on sound principles. But more needs to be done to reinforce the objective that it aims to deliver up to 65-70% of income replacement in retirement for all Australians.

The system's settings should reinforce this objective. Westpac urges the Inquiry to closely examine the regulatory, governance and market structure of the superannuation system to ensure that it is optimally placed to meet the needs of consumers, the financial system and the economy.

To ensure the insurance industry is optimally supporting the Australian economy, an appropriate shared Government and industry vision is required to inform the policy settings for the efficient and effective management of risk. This includes addressing Australia's underinsurance gap, which is widespread. In life insurance alone, the total cost to the Government of underinsurance for life, total and permanent disability and income protection is estimated at around $1.6 billion per annum.

Finally, the growth in superannuation means Australia now has the third largest pool of managed funds in the world. There are undeveloped opportunities to export our funds management services to Asia. A renewed commitment to the recommendations of the Johnson Report is necessary to realise this opportunity.

Westpac **recommends** the Inquiry:

- Reinforces the objective of the superannuation system to aim to deliver up to 65-70% of income replacement in retirement for all Australians;
- Strengthens the regulatory, oversight and governance structures of the superannuation industry;
- Considers measures to address the underinsurance gap by:
  - Removing unnecessary tax complexity;
  - Improving affordability through mitigating against natural disasters;
  - Breaking down barriers across various types of insurance; and
  - Addressing disincentives to insure.
- Considers measures to implement, and build on, the recommendations of the Johnson Review.

Technology in financial services

Technology is a vital element of innovation in financial services and is an important driver of productivity growth in the financial system and economy. The system's regulatory framework should be designed to support, and not unnecessarily hinder, the introduction of new technologies in financial services.

The application of technology to financial services enables the entry of new competitors that may operate outside the regulated system. Westpac supports this competitive tension, but policy makers must remain cognisant of the need to maintain customer confidence in the financial system, and its stability. Any disruption to a service resulting from inappropriately regulated participants could lead to a major loss of confidence in the financial system and economy overall.

Further, the risks associated with new technology in financial services (e.g. cyber-crime) should be appropriately managed for the benefit of customers and the resilience of the financial system.

Westpac believes these issues are best managed through a comprehensive strategy to ensure the financial system's regulatory framework supports technological innovation, while managing potential risks. This strategy should be developed by Government in close consultation with financial sector participants.

Westpac **recommends** the Inquiry:

- Endorses the development of a comprehensive strategy to ensure the financial system's regulatory framework supports technological innovation, while managing potential risks. This strategy should be developed by Government in close consultation with financial sector participants and include:
  - A review of disclosure and ongoing communications requirements for financial products and services to ensure they can be conducted electronically where appropriate; and
  - Updating and implementing the National Cyber Security Strategy to help improve security resilience for all industries, with greater public-private sector cooperation.

Westpac believes the Inquiry is important and timely.

This submission has been prepared in that spirit, and in an endeavour to assist the Inquiry develop a roadmap for the long-term sustainability of a financial system that is already strong and innovative.

Westpac has a deep and active interest in reforms that support the prosperity of its customers, the health of financial service providers and the country's growth.

SUMMARY OF RECOMMENDATIONS (BY CHAPTER)

SUMMARY OF RECOMMENDATIONS (BY CHAPTER)

Regulatory Reform and its Consequences	Westpac recommends: • The Inquiry undertakes a stocktake of the agenda for regulatory reform to evaluate the combined impact of existing and proposed regulation; • Australia's financial system regulators take account of Australia's commitment to the G20 growth and financial system efficiency objectives in their domestic implementation of the global reform program; and • The Inquiry considers ways of streamlining the implementation of regulation by financial system regulators.
Funding Australia's Financial System for Economic Growth	Westpac recommends the Inquiry: • Considers measures for tax equalisation between bank deposits and other competing savings options; and • Considers options to encourage superannuation savings into bank deposits and fixed income securities.
Supporting SMEs	Westpac recommends the establishment of a taskforce comprising Government and industry representatives to examine: • Alternative financing in Australia (such as private equity, start-up and growth funds, venture capital and emerging trends), including current barriers to market development and potential opportunities to enhance the financing mix available to SMEs; and • Opportunities for other forms of non-financial support to be increased, including providing SMEs education to increase awareness of the range of financing options available and improved expertise to apply for external (debt and equity) finance.
Building and Protecting Australia's Wealth	Westpac recommends the Inquiry: • Reinforces the objective of the superannuation system to aim to deliver up to 65-70% of income replacement in retirement for all Australians; • Strengthens the regulatory, oversight and governance structures of the superannuation industry; • Considers measures to address the underinsurance gap by: – Removing unnecessary tax complexity; – Improving affordability through mitigating against natural disasters; – Breaking down barriers across various types of insurance; and – Addressing disincentives to insure. • Considers measures to implement, and build on, the recommendations of the Johnson Review.

SUMMARY OF RECOMMENDATIONS (BY CHAPTER)

Developments in Technology and Payments	Westpac recommends the Inquiry endorses the development of a comprehensive strategy to ensure the financial system's regulatory framework supports technological innovation, while managing potential risks. This strategy should be developed by Government in close consultation with financial sector participants and include: • A review of disclosure and ongoing communications requirements for financial products and services to ensure they can be conducted electronically where appropriate; and • Updating and implementing the National Cyber Security Strategy to help improve security resilience for all industries, with greater public-private sector cooperation.

1

THE LANDSCAPE

CHAPTER 1
THE FINANCIAL SYSTEM SINCE THE WALLIS INQUIRY

1.1 INTRODUCTION

The Australian financial system has performed well in the 17 years since the Wallis Inquiry. It is a well-balanced, sophisticated system that has supported the real economy through economic cycles. By supporting the economy through the GFC, Australia's financial system passed its most significant 'real-life' test since the Great Depression. Moreover, the system has supported Australians to build amongst the highest per capita wealth in the world.

1.2 A SUSTAINABLE FINANCIAL SYSTEM

It is important to have a set of principles against which to assess how the financial system is meeting the needs of its users. The users of the system are customers, shareholders and communities.

Three principles are paramount in assessing the performance of the financial system:

- The **resilience** and integrity of the system;
- The **efficiency** of the system; and
- The **flexibility** of the system to drive, respond and adapt to emerging trends through innovation.

The efficiency of the financial system is judged by its ability to both marshal and allocate savings, and provide financial services at least cost. At times, there may need to be trade-offs between these principles.

Where the resilience, efficiency and flexibility of the system are optimally balanced, the financial system is positioned to most effectively meet the needs of its users.

1.3 THE ROLE OF THE FINANCIAL SYSTEM

The financial system plays a vital role in the economy. It is unnecessary to detail all of its individual functions in this submission. But it is important to consider the rapidly changing nature of the system since the Wallis Inquiry.

New institutions, markets and products have emerged over the past 17 years, while others have been significantly transformed or, in some cases, disappeared.

Factors behind these changes include reforms to taxation and retirement income legislation, customer preferences, technological innovation and shifts in the country's economic makeup.

The financial system will continue to evolve, adapting to change.

1.4 WESTPAC GROUP'S ROLE

Westpac is one of the four major banking organisations in Australia. Founded in 1817 as the Bank of New South Wales, Westpac was the first bank established in Australia and for almost 200 years has contributed to the prosperity of the nation. Westpac has grown, adapted, and strengthened to become Australia's second largest bank.

Westpac provides consumer, business and institutional banking services, wealth management, wealth administration and insurance services to customers across Australia, New Zealand and the Asia-Pacific region.

These services are facilitated and provided through a range of Westpac teams united under a common 'customer-centric' thematic. Those teams include physical distribution, product, marketing, operations and technology, all backed by the core divisions of finance, risk, human resources, compliance and legal.

Westpac also maintains branches and offices in New York, London and throughout Asia. Westpac supports a wide range of stakeholders through our activities and our contributions to the community.

As at 30 September 2013 Westpac had:

- 12.2 million customers;
- 36,000 employees, across the Group's brands and countries of operation;
- Nearly 580,000 shareholders, made up of individuals and institutions from Australia and overseas; and
- Invested 1.3% of pre-tax profit back into the community in the 12 months to 30 September 2013, and over half our employees volunteered or participated in fundraising for a charity of their choice during that period.

Westpac aims to be a resilient and strong organisation. Westpac is:

- One of the top five listed companies on the Australian Stock Exchange (ASX) by market capitalisation ($101.8 billion on 30 September 2013);
- In a strong capital position relative to Australian and international peers, with a common equity tier ratio of 9.1% as at 30 September 2013;
- One of a handful of banks globally with a AA rating;
- One of the most efficient banks globally, with an expense to income ratio of 40.9% on a cash earnings basis;[1]
- A relatively high tax paying company. In the year to 30 September 2013, Westpac made $2.97 billion in total income tax payments representing an effective tax rate of 30.2%;[2] and
- The world leader in sustainability: ranked number one in the 'Global 100 Most Sustainable Corporations in the World' at the 2014 World Economic Forum.

These attributes have supported Westpac's continued contribution to the financial system, and Australia as a whole, through times of national prosperity and through all stages of the economic cycle.

1. In assessing financial performance, Westpac uses a measure of performance referred to as 'Cash Earnings.' Cash Earnings, as calculated by Westpac, is viewed as a measure of the level of profit that is generated by ongoing operations and is expected to be available over the long term for distribution to shareholders.
2. Including life company accounting.

CHAPTER 1
THE FINANCIAL SYSTEM SINCE THE WALLIS INQUIRY

1.5 EVENTS AFFECTING CUSTOMERS SINCE THE WALLIS INQUIRY

Global events, domestic developments, innovation and regulation have all contributed to changes in the way that customers interact with their financial institutions. For the most part these changes have brought benefits to customers. But they have also made the financial system a more complex place for customers and institutions. Examples of these changes are shown in the table below.

Figure 1.1 – Changes affecting customers since Wallis Inquiry

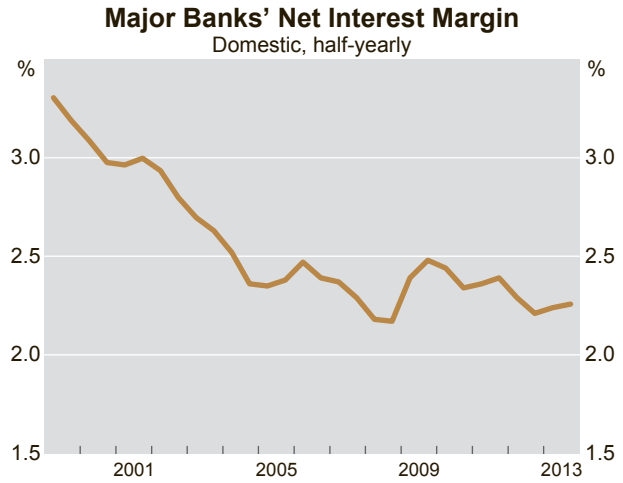
Late 1990s	• Mass popularity and access to the internet – led to more customers preferring to interact with their financial institutions through electronic means.
1999	• Y2K – many customers anxious regarding the security of their savings and information. • Mutuals regulated by APRA – customers provided the same depositor protections as with banks.
2001	• BPay develops a paperless billing system, enabling customers to manage their bills electronically.
2002	• Financial Services Reform Act – customers receiving longer and more complex disclosure documents.
2006	• Introduction of the Anti-Money Laundering Act – customers required to produce more evidence of identity.
2007	• Release of the first Apple iPhone – heralded the growth of customer use of smart phone devices. • Introduction of BT Super for Life – customers able to open a super account at a branch, and view their super and banking together online.
2008	• Onset of the GFC – disruption in global markets, eventually leading to flow-on impacts for customers through the cost and availability of credit.
2009	• Westpac launched its first 'mobile friendly' application for mobile banking.
2010	• Basel III – release of new global capital and liquidity rules. Effects of liquidity rules, in particular, to be felt by customers in terms pricing and product features.
2013	• Westpac establishes '24/7' banking, enabling customers to deposit cash and cheques at any time.
2014	• New Westpac online banking system, built from mobile-first perspective.

1.6 THE BANKING SECTOR SINCE WALLIS

Efficiency

The prices of many bank services and products have reduced over the past 17 years, fuelling demand for and availability of financial services. Major banks' net interest margins have declined by around a third, equivalent to one percentage point since the Wallis Inquiry.

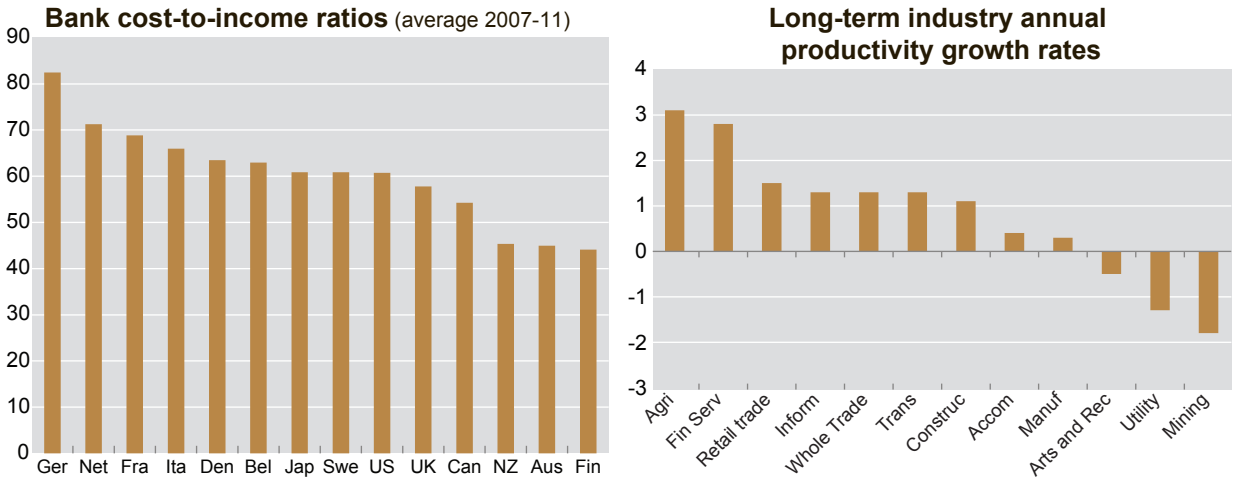
Figure 1.2 – Major banks' net interest margins 1999-2013



Sources: RBA December chart pack 2013, RBA Bulletin Article Banking Fees in Australia June 2013

There has also been a downward trend in banks' cost-to-income ratios as the industry has undertaken significant programs of process improvement. Australian bank cost-to-income ratios demonstrate that the banking system is one of the most cost-efficient in the world. The May 2013 Productivity Commission Productivity Update report highlighted that the Australian financial sector was one of the most productive sectors in the economy over the past 20 years.

Figure 1.3 – Bank cost-to-income ratios and annual industry productivity growth

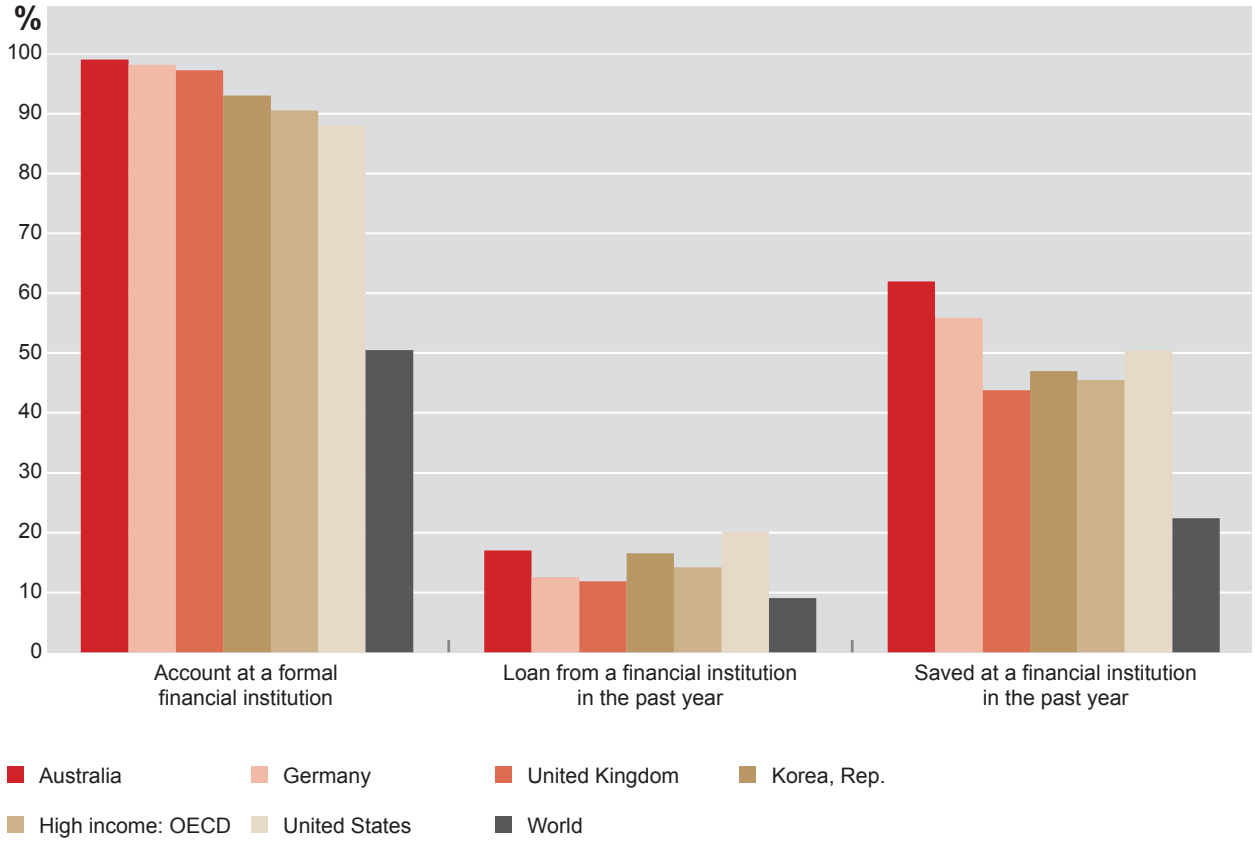


Source: Cross-country compilation of cost-to-income is from World Bank Financial Development database. The productivity growth rates are sourced from the Productivity Commission: Productivity Update May 2013. Data is annual average for period 1989-90 to 2011-12. Productivity is defined as multifactor productivity, the proportion of additional activity not explained by higher labour or capital inputs.

CHAPTER 1
THE FINANCIAL SYSTEM SINCE THE WALLIS INQUIRY

Lower cost, and efficiency, have driven high levels of participation in the financial system. Australians have some of the world's highest financial system participation rates.[1]

Figure 1.4 – Use of banking services, 2011 (population>15)



The participation rates in Australia demonstrate a high level of financial inclusion. Nevertheless, there are Australians that remain excluded from the financial system, in particular, some Indigenous Australians.

Westpac believes five specific elements of financial inclusion are vital:

- Financial literacy;
- Affordable and accessible products;
- Advice;
- Awareness raising; and
- Support for customers in times of difficulty.

It is important that the financial services industry, in partnership with regulators, continues to implement measures to improve financial inclusion, including:

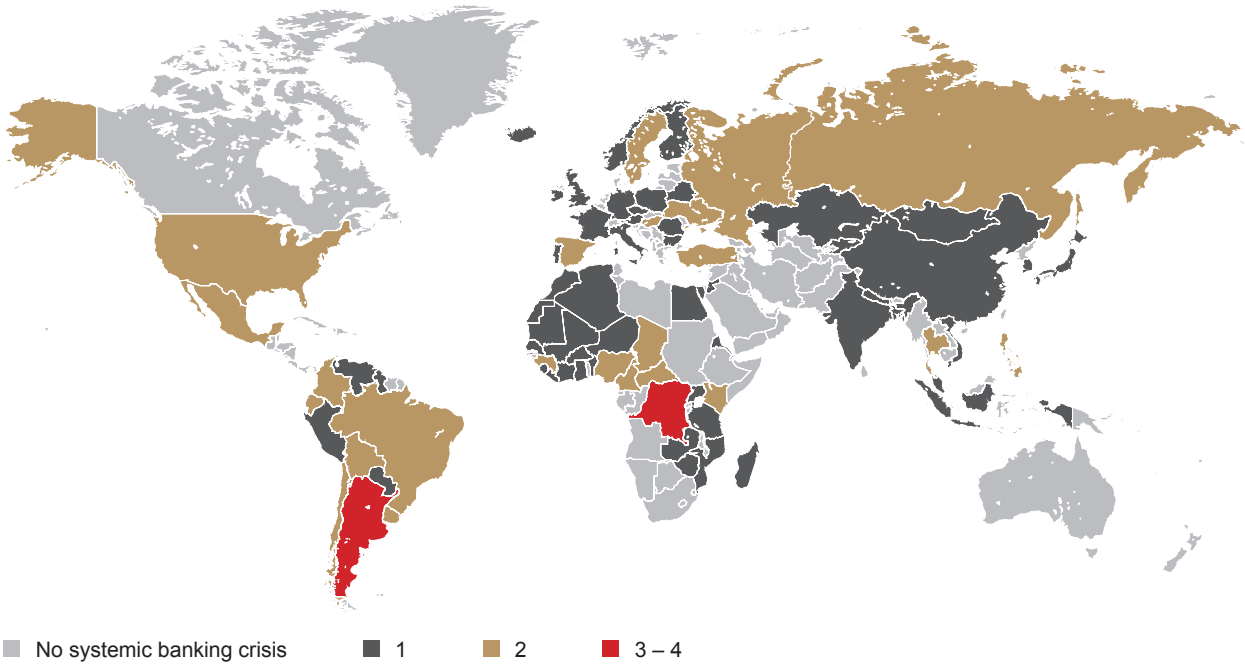
- The Australian Securities and Investments Commission's (ASIC) National Financial Literacy Strategy and Action Plan, to be developed and implemented in consultation with the financial services industry;
- That the work program of the Global Partnership for Financial Inclusion continues to be implemented under Australia's presidency of the G20; and
- That the banking sector continues to facilitate affordable, timely and adequate access to a wide range of financial products and services in line with the Organisation for Economic Co-operation and Development (OECD) definition of 'financial inclusion.'

1. Deloitte. Competiton in retail banking, annexed to Australian Bankers' Association (ABA) Submission.

Resilience

In addition to being efficient, the Australian financial sector has been resilient. Research by the IMF suggests that Australia, New Zealand and Canada are among the few developed countries not to experience a systemic banking crisis over the past 40 years.[1]

Figure 1.5 – Frequency of systemic banking crises 1970-2011



The strong performance of the Australian financial sector has been complemented by a well-functioning regulatory and supervisory system, together with prudent risk management by banks. The 2012 IMF Financial System Stability Assessment stated that:

"Australia's financial system is sound, resilient, and well-managed. Major banks are conservatively run, well capitalised and profitable, and they are likely to withstand severe shocks."[2]

Another reason for the resilience of the Australian banking system is that domestic deposit-taking, lending and payments services are the predominant activity of Australian banks, and, prior to the GFC, trading activities only represented around 5% of major banks' total income.[3] This is in contrast with the heavy focus on investment banking by many global banks – which was a significant contributor to adverse consequences experienced through the GFC, and which aspects of the global regulatory reform program have sought to address.

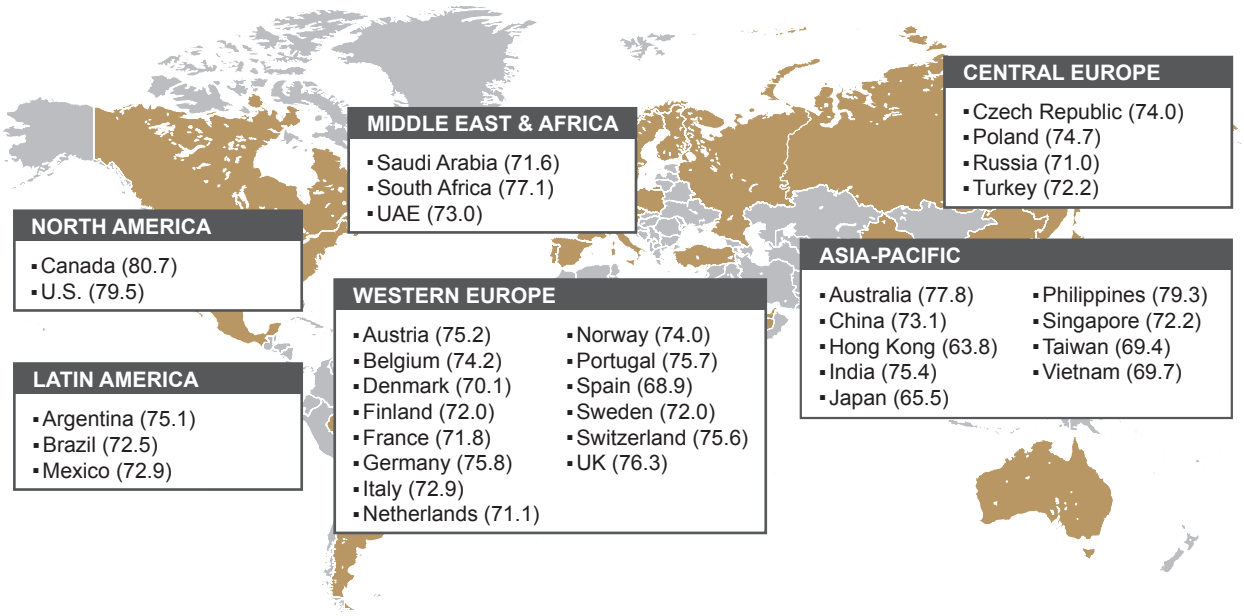
1. Laeven, L and Valencia F. IMF Working Paper 12/163 'Systemic Banking Crises Database: An Update.'
2. http://www.apra.gov.au/AboutAPRA/Publications/Documents/cr12308[1].pdf, at p.1.
3. RBA. Financial Stability Review, September 2009.

Flexibility

The Australian financial system has proven to be flexible and adaptive through innovation, especially with new digital products and services, and in payments. Technological innovation has both reduced the cost of payments and enabled the development of new channels. Further, it has allowed for the entry of new competitors.

Customers are generally satisfied with Australia's banks. In January 2014, satisfaction levels reached 81.6%, the highest level in 18 years, according to research by Roy Morgan.[1] Australia is ranked one of the leading nations in the world in terms of customer experience, ranked fourth in the 'Customer Experience Index' (CEI) which measures customers' banking experience globally across 80 different touch points.[2]

Figure 1.6 – Customer experience index by country



■ Country (2013 CEI score)

1.7 THE SUPERANNUATION SECTOR

The growth in the superannuation sector has been an important feature of the Australian financial system over the past 20 years. Superannuation assets under management grew from around $200 billion in June 1997, to almost $1.5 trillion by December 2013.[3] By some measures, the Australian pension market is the fourth largest in the world.

Compulsory superannuation has provided important benefits. These include increasing the household saving rate, raising retirees' standard of living and reducing what would otherwise have been higher government pension obligations.

Different superannuation vehicles have different asset allocation strategies. They impact on domestic saving and investment decisions in different ways. This has had an important impact on the allocation of capital within the Australian economy and is discussed further in this submission.

1. http://www.roymorgan.com/findings/5451-satisfaction-with-banks-reaches-record-high-201402260024
2. Capgemini and Efma, 2013, Deloitte, Competition in retail banking, annexed to ABA Submission.
3. RBA Statistics. Total assets superannuation funds – outside Life Offices.

1.8 THE REGULATORY LANDSCAPE SINCE WALLIS

In the 1970s, efficiency and innovation in the economy were being excessively inhibited by regulation and government intervention. The Campbell (1981) and Martin (1984) Inquiries considered these issues and provided the foundations for de-regulation of the Australian financial system.

De-regulation has been a key positive feature of the Australian financial system. Among other things, de-regulation has reduced financing constraints, particularly to the household and SME sectors, and has increased availability of finance. It has driven the efficiency improvements in the banking system, noted earlier in this chapter, and improved access to the banking system for foreign entrants.

Overall, the markets-based philosophy has created a financial system that has served the needs of the Australian community well. Key to this philosophy is a principles-based approach to regulation, which means that extraordinary government intervention should only occur where a manifest market failure exists. The GFC illustrated that some changes in regulation in Australia were necessary. But Westpac believes that changes made to financial sector regulation in recent years have in some cases emphasised stability at the expense of efficiency and innovation – these issues are outlined in Chapter 3.

1.9 THE GFC

Constructive efforts involving major banks, Government, regulators and other institutions in the financial system, saw Australia avoid the worst of the GFC. The system, and Australia's economy, remained strong during the crisis and in the period since.

Although the financial system has remained strong, there have been important ongoing impacts of the GFC. Some of these are temporary: for example, as economic conditions improve, customers and businesses are gaining more confidence in the prospects of our economy.

But some changes are likely to be more permanent, including global regulatory reform affecting the cost and quality of funding for the banking system. It is important for the Inquiry to examine these changes in assessing the framework of the financial system and its capacity to support Australia's growth.

1.10 CONCLUSION

Developments since the Wallis Inquiry have seen great change impacting customers, financial providers and the financial system overall. The financial system has continued to drive tangible benefits for customers and fuel Australia's overall prosperity. Important trends will continue to drive change. The financial system needs to be sufficiently resilient, efficient and flexible to meet these changes and drive economic and customer benefits.

CHAPTER 2
SERVING CUSTOMER NEEDS THROUGH COMPETITION

2.1 INTRODUCTION

The financial system meets the needs of customers through offering significant choice, convenience and innovation. Since the Wallis Inquiry, the system has delivered higher quality products, greater access and convenience for customers, and lower costs.

Australia has a broad, integrated and dynamic financial system, highlighted by a diverse range of system participants, including:

- Banks – 'majors,' regional, customer-owned and international;
- Non-banks – credit unions, building societies, finance companies and wholesale lenders;
- Exchanges and trading platforms – for example ASX, Chi-X and Yieldbroker.
- Managed funds – including retail, industry, corporate, public sector superannuation funds, and self-managed super funds (SMSFs);
- Insurance companies;
- International investors; and
- Payment providers - such as Visa, Mastercard and PayPal.

Collectively, these system participants provide the essential functions of the financial system.

This chapter focuses on competition in two vital components of Australia's financial system:

- The sources of financial intermediation; and
- Australia's retail banking system, in particular mortgage lending.

These components of the system are at the core of the financial needs of many Australian households and businesses.

2.2 SOURCES OF FINANCIAL INTERMEDIATION – BANKS AND MARKETS

Australia's financial system primarily provides both bank and market-based financial intermediation to borrowers and investors.

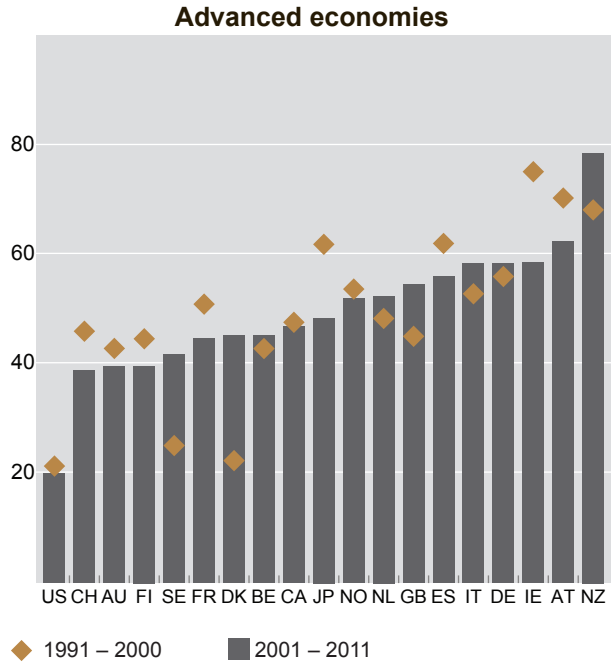
Bank intermediation is an efficient and convenient financing method for households, SMEs and many companies unable to efficiently access markets. Markets-based financing is more prevalent for highly-rated businesses and governments, as their higher credit rating enables them to borrow more efficiently through that channel. Markets also provide a comparatively deep access to equity finance with Australia's primary equity exchange, ASX, listing 2,200 companies and issuers and a total market capitalisation of $1.5 trillion.[1]

Banks do not dominate intermediation in Australia's system. In fact, research by the Bank of International Settlements (BIS)[2] highlights that banks provide a relatively lower proportion of funding to the private sector in Australia than for most international peers, with a larger proportion sourced from markets-based sources.

In the chart below, the ratio of bank credit to the private sector is expressed as a percentage of the sum of bank credit plus bond and equity market capitalisation. A higher value of the indicator suggests a financial structure that is more 'bank-oriented' – it is evident that only the USA and Switzerland are advanced economies less 'bank-oriented' than Australia.

1. http://www.asx.com.au/about/corporate-overview.htm
2. Gambacorta, L, Yang, J and Tsatsaronis, K, BIS Quarterly Review March 2014, 'Financial structure and growth.'

Figure 2.1 – Ratio of bank credit to total private-sector funding (%)[1]



Bank intermediation does, however, play a special role in supporting the resilience of the financial system through economic cycles. The BIS research highlights that in cyclical downturns, banks are more inclined to continue providing credit by drawing upon long-term relationships with customers. By contrast, intermediaries without any direct relationships with borrowers (e.g. markets-based sources) are more likely to reduce or cease the provision of credit during downturns.

The GFC demonstrated that many banks globally were unable to continue providing credit to customers in a crisis (as distinct from a cyclical downturn). However, in a small number of developed economies – including Australia and Canada – the structure of the banking system supported the ongoing provision of credit through crisis conditions. The pertinent features of these banking systems are:

- A limited number of large banks with diverse business models, enabling diversification of risk; and
- A strong regulatory and supervisory system, complemented by the need to supervise a relatively smaller number of participants than in other jurisdictions.

The existence of both competition and stability is vital to the financial system's capacity to support sustainable growth. There may be a 'built-in tension' between the objectives of competition and stability – outcomes of efforts to increase competition may decrease stability, and vice versa.[2]

Policy makers need to be cognisant of this balance when considering measures to enhance both competition and stability in the financial system.

Westpac believes Australia's financial system is both competitive and stable. While the financial system's participants and functions are broad, public commentary on competition typically focuses on Australia's retail banking sector, particularly mortgage lending. This is therefore the focus of this chapter.

1. Countries are: AR = Argentina, AT = Austria, AU = Australia, BE = Belgium, BR = Brazil, CA = Canada, CH = Switzerland, CL = Chile, CN = China, CO = Colombia, DE = Germany, DK = Denmark, EG = Egypt, ES = Spain, FI = Finland, FR = France, GB = United Kingdom, HK = Hong Kong, HU = Hungary, ID = Indonesia, IE = Ireland, IL = Israel, IN = India, IT = Italy, JP = Japan, KR = Korea, MX = Mexico, MY = Malaysia, NL = Netherlands, NO = Norway, NZ = New Zealand, PE = Peru, PL = Poland, RU = Russia, SA = Saudi Arabia, SW = Sweden, SG = Singapore, TH = Thailand, TR = Turkey, US = United States, ZA = South Africa.
2. Bain & Co, Getting bank competition right post-crisis.

2.3 INDICATORS OF COMPETITION IN THE AUSTRALIAN RETAIL BANKING SYSTEM (ACROSS SEGMENTS)

Westpac believes Australia's retail banking system is competitive, and that there are a number of indicators of this competition across the range of product segments.

2.3.1 Level of choice available to customers

Customers enjoy the benefits of a wide range of products, provided by a high number of providers, both Authorised Deposit-Taking Institutions (ADIs) and 'non-ADIs.'[1]

Figure 2.2 – Products on market

January 2014	Total products listed	Total institutions	% Banks	% CUBS	% non-ADIs
Deposit Accounts	681	97	31	67	2
Housing Lending	2000	103	49	24	20
Credit Cards	202	68	48	28	23
Business Lending	226	24	77	22	1
			Banks	**CUBS**	**non-ADIs**
Number of Providers			70	94	23

Source: Canstar

It assists in understanding competition to consider how the industry develops different strategies and products for different customer segments. It is illustrative that even for relatively well-established products such as credit cards, there is competition regarding fee free cards, lower interest rates or introductory balance transfer rates (amongst other features).

For other consumer products such as home loans, customers have available a large range of options through different product features. As shown in the chart above, there are approximately 2,000 mortgage products listed with Canstar.

This level of innovation, product development and choice reflects a highly competitive market.

2.3.2 Market structure

The market structure in the retail banking industry reflects this high degree of competition, with a diversity of competitors with different strategies, sizes and areas of focus. In this regard, banking is very different to some other industries in Australia where only a few very large players may prosper.

In fact, demand for banking services is strong enough to support competition based on a number of strategies. Some banks may, for example, find it profitable to operate in particular regional areas, while others may find it more profitable to target particular customer groups (e.g. business customers), or to specialise in certain product types.

While not all banks participate in all segments, in any one segment there is typically a number of banks competing with one another. It is also important to consider the number of suppliers through the economic cycle, rather than at a point in time (which can be distortive). This is important because market incumbents must compete with other current suppliers, while at the same time anticipating and addressing the competitive threats from new participants in the market.

1. ABA Financial System Inquiry Submission using Canstar data: www.canstar.com.au/ , (January 2014). These figures should be regarded as indicative. Listing a product with Canstar is not compulsory, and generally, credit unions and building societies are more likely to list their products than banks. 'CUBS' is credit unions and building societies.

2.3.3 There is a high level of transparency in the market

A high degree of transparency in a market is generally considered to support competition as it eliminates information asymmetries, enhances customer choice, and allows suppliers to better understand market structure and customer demand.

In the banking industry, there is a commercial and regulatory framework that encourages and facilitates high levels of transparency, including:

- There are a number of private companies that provide data analysis and research in relation to particular segments of the industry;
- The Australian Prudential Regulation Authority (APRA) collects detailed statistics about the industry, with aggregated data being publicly available on a regular basis;
- There is an active market for suppliers of market information services; and
- The regulatory regime in Australia imposes extensive disclosure obligations on banks.

2.4 THE LEVEL OF COMPETITION IN MORTGAGE LENDING

In analysing the level of competition in mortgage lending, it is important to consider the factors underpinning its growth and stability.

2.4.1 The growth of mortgage lending

Demand for property, supported through mortgage lending, has been a key driver of credit growth.

Australia's banking system has facilitated credit growth efficiently and safely, supporting the sustained period of strong economic growth experienced in Australia. Evidence shows that economic growth between 1977 and 2009 was supported by average credit growth between 1.5 to 1.7 times the growth in nominal GDP.[1]

The growth in mortgage lending has supported Australia's high home ownership level compared to peer countries. This has contributed to further economic activity, such as in the construction industry.

Several factors have driven the growth of mortgage lending in Australia:

- A high rate of population growth, almost twice the OECD average since 1997;[2]
- One of the highest levels of urbanisation in the world. Reserve Bank of Australia (RBA) research[3] shows that high levels of urbanisation contribute to house price appreciation, which contributes to credit growth; and
- Australia's high per capita income level and growth has, in turn, supported the high level of credit provision to households.

Government policy has influenced housing credit growth through:

- The structure of the taxation system, such as negative gearing and capital gains tax settings. Since the end of 1996, annualised credit growth for owner occupied housing was 12% compared with 16% for investment properties;[4] and
- Government policies relating to finance for housing, such as subsidies to first-home buyers. According to IMF research, Australia has one of the highest levels of government intervention in the housing finance market amongst developed countries.[1]

1. PwC 'Sustainably funding Australia's prosperity,' December 2013. Annexed to ABA Submission to Financial System Inquiry. See Chapter 4 for further discussion.
2. OECD Statistics: http://stats.oecd.org/index.aspx?queryid=27482
3. Speech by Luci Ellis, Head of the Financial Stability Department, 23 April 2013. 'Housing and Mortgage Markets: The Long Run, the Short Run and the Uncertainty in Between.'
4. Westpac analysis based on RBA statistics.

2.4.2 Stability in mortgage lending

Household credit growth has been underpinned by the stability of mortgage lending, allowing Australia to avoid the systemic issues experienced overseas. Features of stability include supply/demand characteristics and other legal and market characteristics discussed below.

Housing prices

House prices are an important driver of risk in mortgage portfolios. A number of factors have supported fairly consistent growth in Australian house prices over several decades. For example, the process underlying land release for development is complex, which has tended to constrain supply of housing. Further, bank lending to residential property developers is subject to stringent pre-sale requirements, which serves to constrain speculative development.

Other factors underpinning the stability of mortgage lending in Australia include:

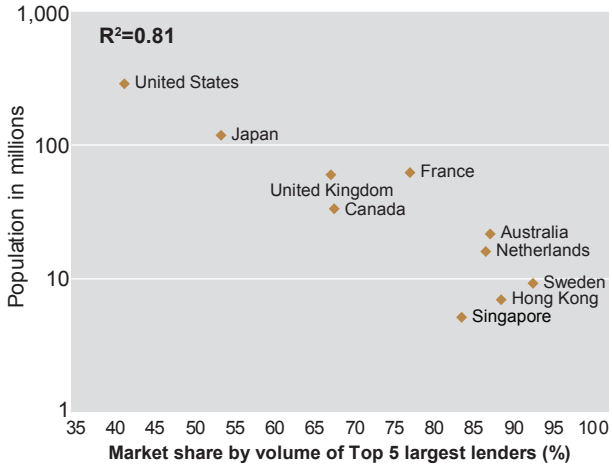
- Underwriting standards – for example, applying 'buffers' to interest rates to ensure that borrowers can continue to service loans even if borrowing rates rise;
- The use of securitisation in Australia for funding rather than risk transfer, leading to an ongoing incentive for lenders to originate high quality mortgages;
- High rates of mortgage prepayment, driven by factors such as non-tax deductibility of interest payments on owner-occupied home loans;
- Full-recourse lending; and
- The rarity of 'honeymoon' period discounts on home loans (common in other countries) where deep interest rate discounts are followed by sharp step-ups in interest rates.

2.4.3 Market concentration and population

There has been much debate, particularly since the GFC, regarding the level of concentration in mortgage lending. This has, to a large extent, arisen from some providers in the system being unable to lend – or exiting entirely – as a result of the crisis. Difficulty in obtaining funding was a key contributor to this.

A given level of concentration does not necessarily translate into a lack of competition. Moreover, there is evidence of a strong correlation between population size and concentration of the top five mortgage lending providers across a broad set of developed countries. From this, it is clear that Australia's current concentration level is consistent with its population size.

Figure 2.3 Market share of Top 5 largest mortgage lenders vs. population [$\log_{10}$(population)][1]



2.4.4 The competitiveness of mortgage lending

Specific characteristics of mortgage lending show it is competitive. These include:

- Contestability;
- The broad and extensive product choices available; and
- Pricing efficiency.

Contestability

Contestability is an important aspect of the competitiveness in Australian mortgage lending. The ability of smaller lenders to effectively win market share from larger institutions is a key indicator of contestability.

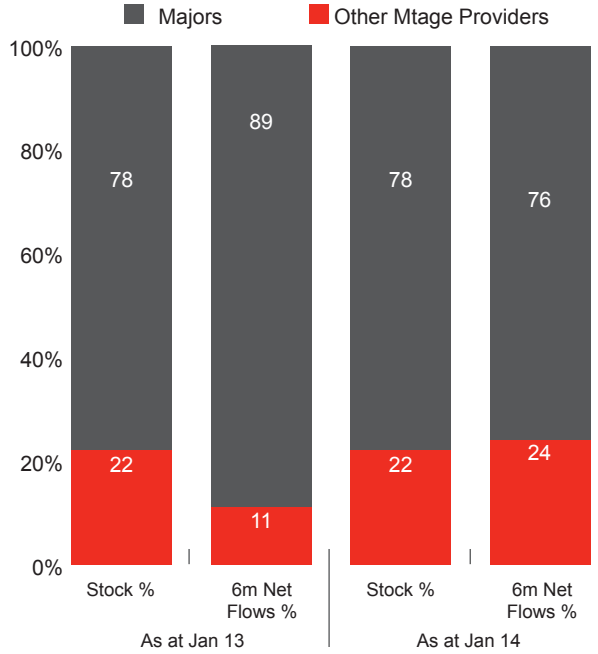
Access to funding, particularly securitisation, was an important contributor to smaller lenders gaining market share from major banks in the period before the GFC. During the crisis, smaller lenders (and in particular non-banks) had the greatest difficulty obtaining funding, with the resultant exit of a number of smaller institutions. This reflected their higher risk due to portfolio concentration, including funding concentration.

Securitisation volumes have increased since the end of the GFC, and there is evidence that issuance activity in 2013 was the strongest since the crisis.[2] This is supporting improving contestability in mortgage lending by smaller lenders.

The graph below highlights this contestability, by reference to the change in major bank and other mortgage providers'[3] share of stock and net mortgage flows.[4] In the six months to January 2014, other mortgage providers have captured 24% of the net flows compared to their market share of 22%. This demonstrates that other mortgage providers have successfully gained market share from the major banks in the six months to January 2014.

1. Oliver Wyman Analysis, 2013. Each unit on the y axis of the chart shows population on an logarithmic scale, with each unit on the axis representing a multiple of ten; Japan for example (y value ~8.1) has just over ten times the population of Sweden (y value ~7).
2. Macquarie Equities Research, RMBS Revival, 6 December 2013.
3. Other mortgage providers include other banks (excluding the major banks) and non-bank lenders.
4. APRA, RBA and Westpac analysis.

Figure 2.4 – Mortgages, share of stock and net flows %



Broad Product Choice

As discussed in Section 2.3.1, there is a significant level of product choice in mortgage lending, with approximately 2,000 housing lending products listed on Canstar.

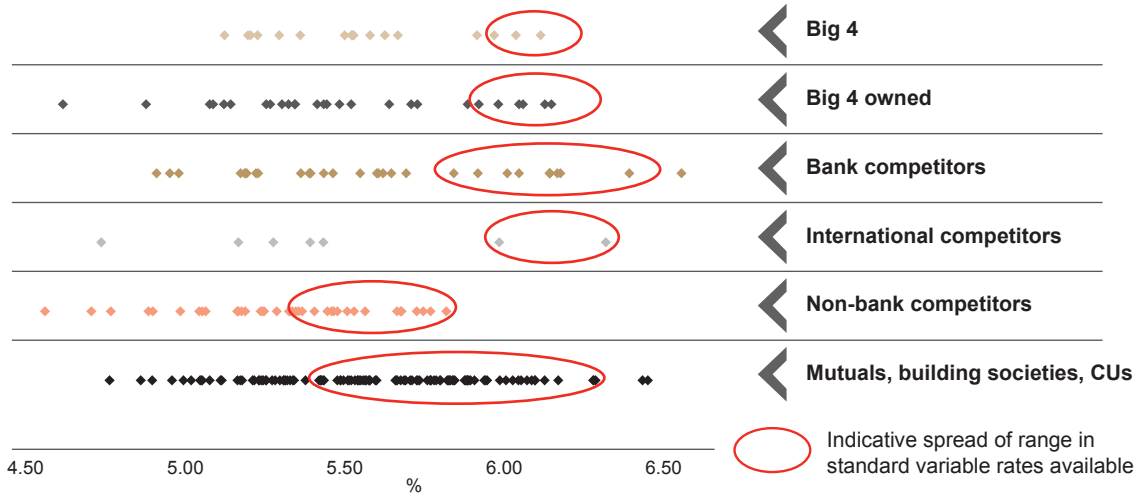
Consistent with that level of choice, home owners have substantial opportunities to switch lenders. For example, a high level of new housing finance each month is refinancing activity, which has increased significantly since the Wallis Inquiry, and has typically averaged between 25-30% of all new owner-occupier housing finance approvals (apart from a brief period following the GFC).[1]

Pricing Efficiency

There is evidence pointing to strong pricing competition in Australian mortgage lending. The chart below shows a comparison of all available variable mortgage products in Australia as at 31 August 2013, on the basis of their rate (adjusted for any fees that may be payable) and differentiated by type of mortgage provider.[2]

1. ABS Housing Finance 5609.0, January 2014.
2. Oliver Wyman analysis.

Figure 2.5 – Comparison of mortgage rates in Australia as at 31 August 2013

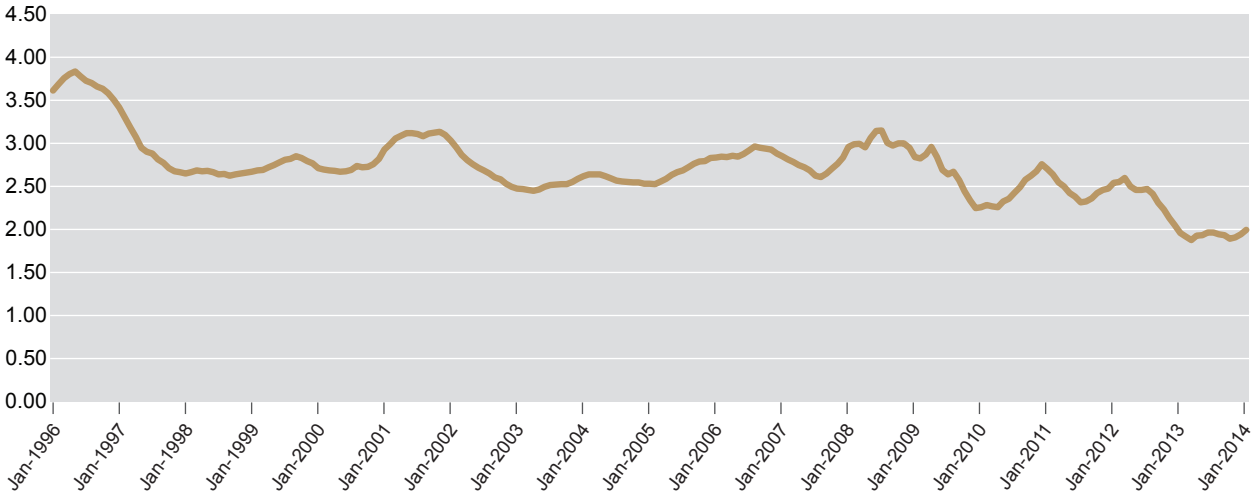


Source: Canstar
Notes: Rates as of 31 August 2013. Rates have been adjusted to reflect total interest and fees payable over the life of a loan.

The chart shows the broad spread of pricing available ranging from 4.5% to 6.5%. It should be noted that the common practice of offering further discounts on top of the standard rates is likely to also contribute to the range of pricing offers.

Price competitiveness and increased funding costs have contributed to the compression in mortgage spreads since the mid 1990s. The chart below shows the spread between the discounted standard variable mortgage rate and six month term deposit rate in the period since 1995. A steady decline is evident.[1]

Figure 2.6 – Discounted standard variable rate to six month term-deposit spread (12 month rolling ave %)



1. Westpac analysis.

2.4.5 Capital allocation and competition

Risk Weights

Australian banks generally use conservative metrics for calculation of capital for mortgage lending.

Westpac uses the Advanced Internal Ratings-Based approach (Advanced IRB) for credit risk and the Advanced Measurement Approach for operational risk. Risk weights are determined by probability of default (PD) and loss given default (LGD). APRA requires that PDs used to determine risk weights allow for the risk of more severe downturns over the course of an economic cycle. Combined with a 20% floor on LGD, capital requirements for mortgages are very conservative relative to historical loss experience.

A comparison of risk weights for mortgages to other asset classes shows differences are consistent with loss experience. For example, Westpac losses on small business loans (excluding loans secured by residential property) have been 13 times higher than mortgage lending, thereby resulting in a commensurately higher risk weight.[1]

Advanced v Standard Capital Accreditation Approaches

There has been recent public discussion that the Advanced IRB approach differentiates between lenders on the basis that financial providers who are not Advanced IRB accredited are required to hold relatively more capital against mortgages. While it is correct that these credit risk capital rules impact the level of capital that accredited and non-accredited banks are required to hold against specific assets, this is a logical distinction arising from different risk assessment methodologies. Further, it is only part of the comparison given other regulatory overlays applied to banks operating with the Advanced IRB approach.

The purpose of the Advanced IRB framework is to create an incentive for banks globally to invest in analytics capability to enhance their risk management capability, and that of financial systems. We note that Advanced IRB accreditation is available to any bank that can meet APRA's prudential requirements.

To achieve Advanced IRB accreditation, Westpac undertakes significant investment in credit risk management, modelling and reporting, which is ultimately reflected in the quality of Westpac's credit risk processes and decisions. Banks operating under the Standardised approach are able to operate with simpler, cheaper risk processes.

Capital comparisons between the Advanced IRB and Standardised approaches also need to consider other levels of risk identified and allocated under the Advanced approach. These include Interest Rate Risk in the Banking Book, Regulatory Expected Loss charges, higher charges for off-balance sheet exposures and Domestic Systemically Important Bank (D-SIB) loadings for the four major banks.

1. Westpac Pillar 3, discussed further in Chapter 5.

2.5 COMPETITION IN OTHER BANK SEGMENTS

Customer Deposits

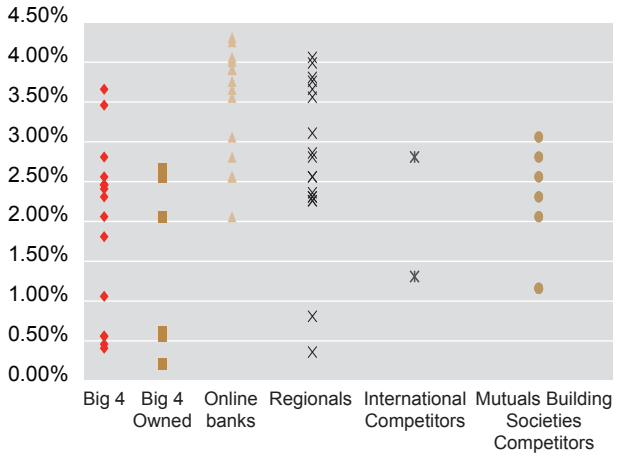
There has been increased competition in pricing of deposits following the GFC, as high-quality funding has become more important for banks. This has resulted in customers enjoying higher rates on deposit products.

In terms of customer choice, there are more than 440 deposit account products available in the market.[1] These products range from transaction accounts to bonus interest accounts, online savings accounts, traditional savings accounts and term deposits. Westpac offers customers 46 deposit accounts across its banking brands.

Business Deposits

Across the range of providers, there is a significant level of price differentiation in business deposit products, which include business savings, cheque and transaction accounts (of no fixed maturity).

Figure 2.7 – Business Savings Accounts Pricing



Source: A sample of 22 ADI websites as at 24 January 2014. Rates quoted are the highest rate available on a published interest rate for an account. Where bonus rates are available, both the standard and bonus rate are included.

There is also a significant level of product differentiation and choice. Most market participants offer at minimum:

- Transaction accounts;
- High performance savings accounts;
- Online savings accounts; and
- Term deposits.

In addition to the basic accounts, the business deposits market extends to a wide range of payable and receivable products, and account structuring solutions.

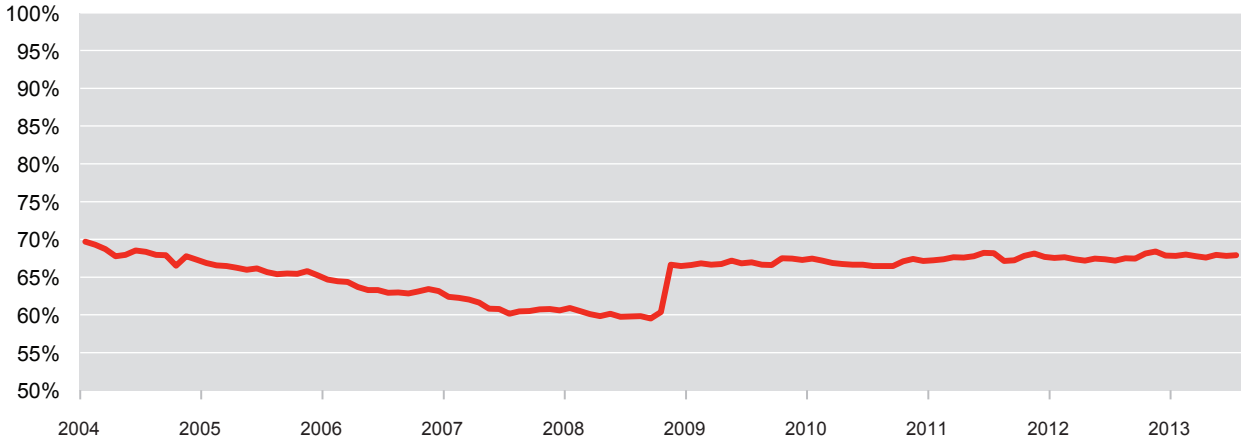
Credit Cards

Australians have comparatively high levels of credit and debit card usage, well over the high income OECD average as a percentage of population over 15 years of age.[2]

1. Cannex Canstar 2014.
2. Deloitte. Competition in retail banking 2014, Chapter 5, annexure to the ABA Submission to the Financial System Inquiry. 2011 data, population over 15 years of age.

The credit card segment is intensely competitive, with a range of interest rates, purchase rate and fee offerings. Adding to this intensity is the substitution of credit cards with debit cards, as customers reduce their credit requirements and use existing funds. The major banks' market share in the credit card segment has changed little since the 2000s and remains lower than in 2004.

Figure 2.8– Major banks' share of credit card balances (% of financial system)



Source: APRA Banking Statistics, RBA Payment System Statistics

2.6 MAJOR BANK PROFITABILITY

There has been public discussion regarding the profitability of Australia's major banks as an indicator of a lack of competition in the banking system. However, evidence demonstrates that major banks' returns do not stand out when compared with those of companies in other Australian industries, and other banks overseas:[1]

- No Australian bank featured in the top 50 most profitable S&P/ASX 200 companies in Australia ranked by return on equity (ROE) in 2013;
- The profitability of the Australian major banks is not out of step with banks of other countries that successfully navigated the GFC. The Australian major banks delivered ROEs of between 13-19% in 2013, compared to, for example, Canada's bank ROEs of 14-23% in the same period; and
- Banks in countries that were more impacted by the GFC, such as the US, UK, France and Spain naturally show much lower ROEs at this point. However, average ROEs for the major UK banks were 22-23% in the two years prior to the GFC, compared with ROEs close to 20% for Australia's major banks in the same period.

2.7 ACCESS TO FUNDING AND COMPETITION

As outlined earlier, funding is one of the most important hurdles that new competitors face in banking. Westpac supports measures that enhance the financial sector's existing funding base and therefore drive increased competition. A number of these options are discussed in Chapter 4.

2.8 CONCLUSION

Australia's financial system is dynamic, diverse and competitive, with a range of participants and offerings for customers. The system has also demonstrated its resilience, particularly in supporting Australia's economy through the GFC.

Westpac supports measures that enable competitive tension in the market to flourish in an environment where the strength of the system is maintained. In considering competition, policy makers must be cognisant of maintaining the strength of the system as a vital enabler of sustainable growth through the economic cycles.

1. ABA Submission to the Financial System Inquiry, Chapter 4.

CHAPTER 3
REGULATORY REFORM AND ITS CONSEQUENCES

3.1 INTRODUCTION

The financial system's regulatory framework is critical to the system's ability to meet the needs of customers, and to support the nation's growth. Efficient regulation is necessary for a well-functioning financial system.

Australia has a multi-layered financial services regulatory framework. Financial services providers operate within a complex and robust system of Commonwealth and State/Territory regulation and extensive international regulation.

Banking is one of the most heavily regulated sectors of the Australian economy and Australia is ranked one of the world's leading nations for the soundness of its banking sector.[1]

But regulation that places an excessive emphasis on stability at the expense of efficiency and growth – or that is implemented in a way that creates undue cost – reduces the capacity of the system to meet customers' needs.

Excessive or inefficient regulation can also promote the excessive growth of 'shadow' sectors. These, in turn, create potential risk for customers and the financial system overall.

Regulation should aim to achieve a balance between:

- Increased resilience of the system;
- The costs of implementation and compliance;
- The risks it seeks to mitigate; and
- The overall impact of its implementation on regulated entities, their customers, the community and the economy as a whole.

There has been a plethora of regulatory change since the GFC, from global and domestic sources. These changes have not always appropriately supported growth or the needs of Australian customers. In fact, in many cases, Australia's financial system has borne the cost of failings overseas or regulatory reform unrelated to Australia.

The volume of global regulatory reform has also placed a significant burden on Australia's domestic regulators.

In Westpac's view, there is much to be gained by undertaking a stocktake of the agenda for regulatory reform to evaluate the combined impact of existing and proposed regulation. Further, streamlining the implementation of new regulation affecting the financial system should also be considered.

3.2 THE GFC AND RESULTING REGULATORY REFORM

Australia's response to the GFC, prudent economic management, and strong supervision of the financial sector, no doubt contributed to Australia retaining its place on the diminishing list of AAA rated countries. Australian major banks took early action raising significant additional capital between 2008 and 2010. Australian banks are now better capitalised than they had been previously. This meant that when APRA followed international supervisory practice and tested whether bank balance sheets were resilient to economic stress, no capital shortfall was found in Australia's banking system.

Globally, the turmoil and subsequent economic impact of the GFC exposed the need for reform of the financial sector in many nations. G20 leaders decided to focus on four key areas of reform:

- Increasing the resilience of financial institutions, particularly through enhanced capital and liquidity requirements (Basel III);
- Tackling the problems associated with global systemically important financial institutions (SIFIs);

1. World Economic Forum 2011-2012 Global Competitiveness Report, http://www.weforum.org/reports/global-competitiveness-report-2011-2012.

- Improving the over-the-counter (OTC) derivative markets to limit contagion, and hence systemic risk, in these markets; and
- Addressing the risks posed to the financial system by "shadow banking" – i.e. entities and activities outside the regulated banking system.

In Australia, many of these global regulatory reforms have been implemented more quickly and conservatively than elsewhere.

As well as regulation originating from overseas, Australia has seen a rapid growth in the volume of domestic financial services regulation. The Australian Government and regulators have introduced a significant amount of new regulation designed to strengthen the safety of the system, or to address perceived consumer protection concerns.

Westpac believes it is important for the Inquiry to consider the combined impacts of these changes.

These post-GFC reforms are well known, and this chapter does not attempt to outline them in detail. However, in assessing the combined impacts of these changes, and considering improvements in the implementation of regulation in Australia, it is important to briefly take stock of these reforms.

3.3 THE G20 REFORM PROGRAM

Westpac supports Australia's participation in global markets and the country's reliance on overseas capital means domestic regulators should continue to remain cognisant of the global reform agenda. Westpac also appreciates that Australia, as a member nation of G20, is committed to the reform agenda.

But we strongly suggest that implementation needs to be tailored to Australia's circumstances.

The key planks of the G20 reform program are:

- Basel III – which has improved the safety of financial systems globally. However, its cumulative impacts have resulted in increased compliance expenditure, and its liquidity reforms (the Net Stable Funding Ratio and Liquidity Coverage Ratio) may affect the lending capacity of banks. The impact of Basel III is discussed further in this chapter;
- Systemically Important Financial Institutions – APRA has identified the four major Australian banks, including Westpac, as D-SIBs, and proposed an additional Higher Loss Absorbency requirement of 1% of common equity Tier 1 capital for each;
- Over the Counter Derivatives – G20 member jurisdictions have been progressively implementing the necessary legislative and regulatory changes to satisfy the G20 reform of global OTC derivatives markets. However the end-2012 deadline was not fully met by any jurisdiction;
- Shadow Banking – the G20 is seeking to strengthen the oversight and regulation of the shadow banking sector to mitigate systemic risk. In Australia, regulators have focussed less on shadow banking because they believe the shadow system in Australia is much smaller and less systemically relevant. The Council of Financial Regulators undertakes regular reviews of the sector to determine any emerging system risks; and
- Global reform on asset risk weighting – There have been global discussions regarding improvements to the consistency, comparability and simplicity of the risk weighting of banks' assets. It is appropriate to examine opportunities for improving these attributes. But this should not detract from the risk management focus and capability of institutions – for example, through measures such as standardising risk weights. Such measures would reduce the incentive to appropriately price for economic risk, reduce the ability of banks to apply long-standing expertise to credit decisions, and provide a disincentive to investment in risk management.

Other Global Reform Measures

In addition to the above, there have been a range of measures implemented or underway which are relevant to the G20 objectives. These include reforms relating to large exposures, securitisation markets and remuneration frameworks. Certain macro-prudential measures, such as dynamic Loan to Valuation Ratio (LVR) caps, are also being discussed as potential global reforms.

Further, regulation dealing with the risk to customers of banks' controls or operations failing ('Conduct Risk') is an increasing area of focus for overseas regulators, such as in the UK. This regulation has essentially arisen as a 'crisis response,' arising from deficiencies in financial services practices in offshore jurisdictions. This is also an increasing area of focus for Australian regulators, albeit to a lesser extent than overseas regulators at this point.

This regulation is leading to a 'seller-beware' approach with today's high standards being applied with retrospective effect. In some nations, the uncertainties created by regulation made as part of this response are leading to the serious and unintended consequence of financial exclusion. For instance, some financial services providers have withdrawn from the provision of financial advice to certain consumers or even the provision of financial services products to other financial service providers (such as money remittance and correspondent bank services) due to reputational, liability or contagion risk concerns.

While customer protection is and will remain an essential goal of financial regulation, the Australian regulatory framework should continue to be appropriately balanced to ensure that these unintended consequences are not replicated here.

If inappropriate balances of customer protection against individual responsibility for the outcomes of normal risk taking are struck, this could lead to cost and access issues for normal consumers collectively in order to 'insure' against adverse outcomes for some customers.

3.4 DOMESTIC REGULATION SINCE THE GFC

In addition to the implementation of global regulation in Australia, the Federal Government introduced a large number of domestic reforms for the financial services sector following the GFC. These are predominantly focused on consumer protection and have touched most retail and SME banking and wealth products. These reforms include:

- The National Consumer Credit Protection regime;
- The 'Competitive and Sustainable Banking System' reforms introduced in 2010;
- Stronger Super Reforms;
- Future of Financial Advice (FoFA);
- Privacy law reforms;
- Anti-money laundering requirements; and
- Other domestic reforms such as national consumer unfair contracts and changes to the unclaimed monies regime.

Many of these reforms were supported by the industry and their policy goals are sound. However, in practice, the process and detail have frequently proven challenging. This is not necessarily a function of the subject matter of the regulation, but rather the identification of its impact, and its implementation. There are opportunities for enhancing the efficiency of reforms in delivering their policy objectives, discussed in Section 3.6.

CHAPTER 3
REGULATORY REFORM AND ITS CONSEQUENCES

3.5 ISSUES AND IMPLICATIONS OF REGULATORY REFORM SINCE THE GFC

The implementation of such an extensive range of both international and domestic reforms has significant implications for Australia's financial system. Specifically, it has seen the emergence of several issues and trends that are important for the Inquiry to consider:

- The cost of regulation and its impact on credit cost and availability;
- The volume of regulation and its impact on organisational focus; and
- Compliance with extra-territorial rules.

3.5.1 Cost of Regulation

Regulation comes at a cost.

The cost of the global and domestic reform agenda surfaces in three forms:

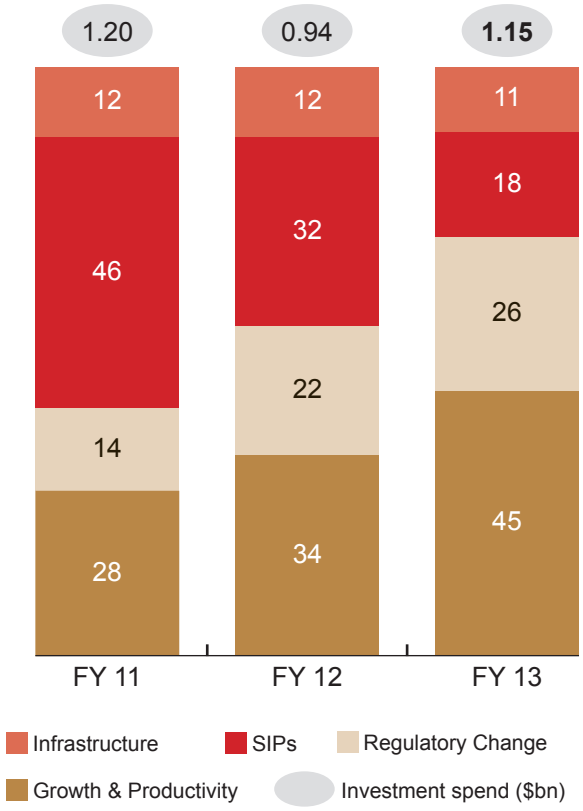
- The cost of implementing regulatory change in institutions;
- The cost and availability of credit; and
- Shifting organisational focus away from risk/return decisions that support growth.

Regulatory Change Costs

In the 12 months to 30 September 2013, 26% (or $302 million) of Westpac's total investment expenses related to regulatory change, with a similar level of expenditure expected in the 2014 financial year.

This has substantially increased from $55 million in the 2005 financial year. In terms of the recent overall reform program, the costs of implementing these reforms are in excess of $1 billion over five years.

Figure 3.1 – Westpac Group composition of investment spending 2011-2013 financial years



Source: Westpac Group 2013 Full Year Results Presentation

Westpac's change capacity and pool of investment spending is finite. The overall level of spending is determined primarily by business performance and competitive pressures. Within this finite pool, regulatory change investment is prioritised over other categories, as it is required for compliance with law.

Westpac endeavours to optimise regulatory change investment wherever possible. However, there is necessarily a trade-off between the level of required regulatory change expenditure versus other investment categories, such as growth and productivity. The higher the level of required regulatory change investment, the lower the capacity to fund other kinds of investment. This capacity is both financial and operational.

Increasing the cost of, and constraining the capacity to supply credit

One consequence of the Basel III capital and liquidity rules will be to make credit more expensive. The Basel III capital reforms not only require that banks hold more capital to support asset creation, but that capital must be of a higher quality. Higher quality capital is more expensive.

There is the risk that the Basel III liquidity reforms may affect the lending capacity of Australian banks. The Liquidity Coverage Ratio (LCR) will require that a greater proportion of deposits and other liabilities are held in the form of high quality liquid assets rather than being directed to productive lending.

The Net Stable Funding Ratio (NSFR) will require that lending activity is supported to a greater extent by more stable funding, in general directing liability raising activities towards retail deposits and long term wholesale funding. These sources of funding are relatively more expensive than less-stable sources. In recent years, the price impact of this has been readily apparent in the retail deposit market, but in the future, price alone may not be sufficient to address the capacity of the market to supply stable funding to support credit growth.

In seeking to comply with the LCR requirements, banks will be required to hold significantly higher amounts of very low yielding high-quality liquid assets. In addition, due to the lack of liquid assets in Australia which qualify for inclusion in the LCR (predominantly government debt), a Committed Liquidity Facility (CLF) will be made available by the RBA which can be utilised to meet the LCR requirement. The CLF will be available to Australian ADIs that are subject to the LCR requirement. All commitments to ADIs under the CLF will attract a commitment fee.

In addition, there is an emerging trend of overseas regulators seeking to address what they see as excessive short-term borrowing by banks from their markets, with a particular focus on foreign banks. This could have negative capacity implications for the Australian banking system, particularly when credit demand increases.

3.5.2 Organisational focus

The uncertainty created by the sheer volume of regulatory reform undertaken has shifted the focus of major institutions towards compliance, and away from innovation and risk/return decisions that support economic growth.

The extent and continuous nature of the reform program challenges the ability of institutions to plan significant new investment, or develop businesses that promote greater credit formation.

As many measures are new, their impact on markets is yet to be determined or properly understood.

3.5.3 Extraterritoriality

A number of regulations introduced by nations for domestic reasons have had extraterritorial impacts in Australia. The US Foreign Account Tax Compliance Act (FATCA) is an example. In some cases the extraterritorial effects of legislation do not appear to be intended and, if left unchanged, will make compliance challenging.

For example, Westpac has had to undertake significant investment to develop customer identification systems to meet the FATCA requirements that do not stem from any deficiency in Australia's financial system.

A further example is the Dodd-Frank Act of the US. As part of that, the Volcker Rule, which was intended to limit excessive risk taking activity by large US banks, has led to Australian banks re-evaluating and re-structuring a range of legitimate business activities to ensure compliance.

Similarly, the extensive reach of the OTC derivative regulations has caused a number of jurisdictions including Australia to accelerate development of legislative and regulatory regimes, and led to significant compliance investment by Australian banks.

This is due to certain broad definitions or specifications incorporated in the US legislation, which were designed to circumvent undesirable derivatives activities that have not been evident in the Australian market.

Due to Dodd-Frank, Australian banks will be subject to additional costs and constraints over and above agreed G20 and domestic Australian policies. This will have a negative impact on the efficiency of domestic financial markets, and hence the provision of risk management services to customers.

Westpac fully supports the efforts by the Australian Government to achieve substituted compliance outcomes wherever practicable with foreign governments, in areas where domestic legislation produces an equivalent or better regulatory outcome.

Westpac further believes that Australia, through its representation on international regulatory agencies (particularly the Financial Stability Board), should promote a formal requirement that member jurisdictions evaluate extraterritorial impacts when developing their domestic regulation.

3.6 STREAMLINING THE IMPLEMENTATION OF REGULATION

To help address the impacts of regulatory change described above, the Inquiry should focus on streamlining the implementation of regulation in Australia's financial system. There are two focus areas to achieve this:

- The G20 and Australia's Presidency; and
- Refinements to certain aspects of Australia's supervisory framework.

3.6.1 The G20 and Australia's Presidency

On the eve of the Meeting of G20 Finance Ministers and Central Bank Governors in Sydney in February 2014, Treasurer Joe Hockey said:

"2014 is the right time to begin transitioning the financial regulation agenda from one of 'crisis response' towards, ultimately, a more stable and predictable framework."[1]

The Treasurer went on to state that G20's objective for the regulatory environment should be to foster confidence and growth. The G20 Communiqué following that meeting stated that policies would be developed with the aim of achieving a specific growth objective of lifting collective GDP by more than 2% above the current implied trajectory over five years.

Further, within the general framework of that growth objective and with specific regard to the regulatory environment, the G20 Communiqué endorsed the promotion of confidence and growth and stated:

"We will implement these reforms in a way that promotes an integrated global financial system, reduces harmful fragmentation and avoids unintended costs for business."[2]

From Australia's perspective, it is important that local financial system regulators take account of Australia's commitment to the G20 growth and financial system efficiency objectives in their domestic implementation of the global reform program.

It is incorrect to assume that the global regulatory reform agenda has been completed or that the impacts on institutions will shortly subside. As the Chairman of the Basel Committee Stefan Ingves noted in a recent speech:[3]

"Let me sum up by returning to that Swedish proverb: 'The devil is in the boat, and now we have to row it ashore'…As we go forward, we will inevitably find things that need adjusting."

Undertaking a stocktake of the financial system impacts of post-GFC regulatory change would inform appropriate settings for existing reforms currently being implemented, as well as the settings of proposed future reforms. This is because, in addition to the reforms currently being finalised and implemented, further proposed regulatory reforms are being considered including in relation to bank resolution frameworks, bail-in, shadow banking and risk weighting of assets.

The cumulative effects of the current reform program should be assessed before the implementation of such measures in Australia is determined.

1. http://jbh.ministers.treasury.gov.au/speech/002-2014/
2. Paragraph 10, Communiqué, Meeting of Finance Ministers and Central Bank Governors, Sydney, 22-23 February 2014.
3. http://www.bis.org/speeches/sp140131.htm

3.6.2 Refinements relating to Australia's supervisory framework

Westpac believes there are some fundamental principles that should apply to Australia's regulatory and supervisory framework. These are that it:

- Supports a stable, efficient financial system and promotes confidence for all participants;
- Keeps pace with dramatic changes and innovation in the financial system;
- Ensures a transparently coordinated, efficient approach with little confusion between regulators over jurisdiction (particularly in a crisis situation) and without overlap;
- Does not detract from the ability to provide specialised and focused regulatory outcomes;
- Is risk-based, targeting the areas where supervision and regulatory responses are needed most;
- Remains appropriately accountable and subject to reasonable checks and balances; and
- Ensures Australia remains internationally competitive.

Australia's current supervisory framework demonstrates many of these features.

That said, the Australian regulatory environment remains unnecessarily complex. For example, Westpac is subject to a large number of regulators and quasi-regulatory bodies. This complexity affects the efficiency with which regulation is implemented.

There are three main areas for streamlining implementation of regulation by Australian financial system regulators:

- Improved overall regulatory accountability, efficiency and coordination;
- Improved regulatory reporting; and
- More transparent and consistent regulatory consultation and impact analysis processes.

Specific opportunities for streamlining regulatory implementation within each of these categories are discussed in **Appendix 1**.

3.7 CONCLUSION

The volume of regulatory change since the GFC has been significant for the financial system's ability to support economic growth and most efficiently meet the needs of its users. Safeguards to ensure the resilience of the system are important, but in many ways Australia's system was already significantly stronger than systems overseas. The GFC did not expose systemic risks here that were exposed elsewhere.

Regulatory reform needs to reflect domestic circumstances and is best done consistently, consultatively and with emerging trends in mind.

Westpac GROUP

Recommendations

Westpac recommends:

- The Inquiry undertakes a stocktake of the agenda for regulatory reform to evaluate the combined impact of existing and proposed regulation;
- Australia's financial system regulators take account of Australia's commitment to the G20 growth and financial system efficiency objectives in their domestic implementation of the global reform program; and
- The Inquiry considers ways of streamlining the implementation of regulation by financial system regulators.

2

CHALLENGES AND OPPORTUNITIES FOR THE AUSTRALIAN FINANCIAL SYSTEM

CHAPTER 4
FUNDING AUSTRALIA'S FINANCIAL SYSTEM FOR ECONOMIC GROWTH

4.1 INTRODUCTION

The quantity and quality of funding available to the financial system is central to its ability to fund the economic activities of customers. A system that can meet the funding needs of customers – through all economic environments – is one that is sustainably supporting Australia's growth.

The composition of the national savings pool is the most important factor for the system's ability to continue driving growth. The current taxation treatment of savings and investment has created distortions; this is particularly so for savings directly into the banking system. In certain scenarios these distortions could have important and lasting consequences for the Australian economy.

A key part of the financial system's support of economic growth is through bank intermediation. Bank intermediation is most efficiently supplied from the highest quality funding sources.

Westpac urges the Inquiry to consider new options for increasing the supply of highest quality funding for bank intermediation. The primary options for achieving this outcome are:

- Equalising the tax treatment between bank deposits and other competing savings options; and
- Encouraging the investment of superannuation into bank deposits and fixed income securities.

Other complementary measures for increasing the existing funding base for the financial system include supporting the growth of the securitisation market, encouraging a deeper Australian corporate bond market and broadening the interest withholding tax exemption. These measures would also support further competition in the financial system through diversifying the funding base available to financial institutions.

4.2 FINANCING CHANNELS IN THE FINANCIAL SYSTEM

Different financing channels are important for different sectors of the economy, as shown below.

Figure 4.1 – Real economy funding sources at September 2013 (% of each sector's total liabilities)[1]

Asset Classes	Households	Non-financial corporates	Government[2]
Bonds	–	7	50
Loans	94	27	30
Listed equity	–	34	–
Unlisted equity	–	22	9
Other	6	9	11

In summary:

- Loans are the major source of financing to the non-financial private sector;
- Loans are the most important source of funding for households, and the most important non-equity source of funding for the non-financial corporate sector; and
- Bonds are a more important source of debt funding for the Government sector.

Significantly, approximately 90% of total loans are made by banks.

1. Australian National Accounts; Financial Accounts, September 2013 5232.0. The real economy excludes funding to the financial sector.
2. Unfunded superannuation claims are excluded from total Government liabilities. The Government sector includes the Commonwealth and state and local general government sectors, government non-financial corporate sectors and central borrowing authorities.

4.3 THE BANKING SYSTEM IS VITAL TO FINANCING THE AUSTRALIAN ECONOMY

As outlined in Chapter 2, while Australia's financial system provides both bank and market-based financial intermediation, bank intermediation plays a vital role in supporting the resilience of the financial system through economic cycles.

Bank intermediation has the necessary regulatory and supervisory framework, credit assessment skills, technological infrastructure, scale and efficiencies, broad distribution networks and competitive tensions to support a high and sustainable level of credit provision, and hence economic growth into the future. It:

- Reduces risk by spreading the risk of one borrower across a portfolio of multiple loans and investments (credit transformation);
- Reconciles the conflicting preferences of lenders and borrowers, in terms of maturity, interest rates and loan conditions (maturity transformation); and
- Provides market liquidity (liquidity transformation). This is the process where banks take the savings that have been invested into liquid products (typically deposits) and provide the funds to borrowers in the form of illiquid loans.

Banks also capitalise on the experience of a large number of personnel that form a significant skill base in credit decision-making. For example, Westpac employs more than 700 people dedicated to the bank's credit risk areas, and there are approximately 11,500 individual, non-automated credit decisions made each week for mortgages, business banking, SMEs, credit cards, personal loans and transactional banking.

This expertise requires significant investment over a long period of time, and is an inherent strength of Australian banks compared with non-bank options.

4.4 THE BANKING SYSTEM'S FUNDING TODAY

The Australian financial system is such that the volume of available customer deposits is not sufficient to meet the demand for loans from customers. Wholesale borrowings, both long and short term, are required to make up the shortfall; typically, wholesale borrowings make up approximately 30% of the Australian major banks' total funding. Customer deposits provide a further 60% of total funding, the remaining 10% coming from equity investment.

Wholesale domestic debt markets supplement customer deposits by providing an additional means for Australians' savings to make their way into the banking system. Due to its relatively small size, however, the domestic wholesale market alone does not satisfy the gap between deposits and loans. Funds are therefore sourced from offshore debt markets that are then used to fund loans to Australian individuals and businesses.

For Westpac, wholesale borrowings from domestic debt markets comprised 12% of total funding as at 30 September 2013. Offshore markets make up an additional 18% of total funding. The bank has been successful in attracting funds from a wide range of sources, across geographies, and across maturities. In this way, wholesale funding sources are able to be diversified and liquidity risk reduced.

Australian banks benefit from their relatively high credit ratings. This is supported by their strong financial, risk, capital and funding profiles, conservative business models, appropriate lending policies, the banks' relative size and by Australia's sovereign AAA credit rating. All these factors enable Australian banks to achieve relatively high credit ratings that in turn underpin the ability to attract funds at an efficient cost.

CHAPTER 4
FUNDING AUSTRALIA'S FINANCIAL SYSTEM FOR ECONOMIC GROWTH

Without the ability to attract wholesale funds at efficient cost, Australian banks would either have to constrain their lending and investment activities to remain in line with the level of available customer deposits, or undertake these activities at a significantly higher cost. This would either:

- Increase the cost of lending to customers;
- Reduce lending overall;
- Reduce bank returns and dividends; or
- A combination of these factors.

Ultimately, the sum of these effects would have the impact of reducing economic growth.

4.5 BANK FUNDING PRIOR TO THE GFC

Over the past 20 years easier access and cheaper availability of credit meant households were able to borrow more money at lower cost than previously. At the same time, the composition of household savings moved away from bank deposits. Changes to the retirement income system in the 1990s directed the domestic flow of funds away from the liability side of banks' balance sheets. The expectation of better returns encouraged flows into other asset classes (notably equities and property). This was reinforced by the relative tax treatment of deposits compared to other asset classes.

These trends led to the demand for lending significantly outpacing the supply of deposits. Australian banks used their ability to borrow funds from global wholesale markets to fund a much larger part of their lending activities. As at April 2009, wholesale borrowings made up approximately 44% of the major banks' total funding.[1] In this effort they were aided by a high level of liquidity in global markets making wholesale funds readily accessible and at a lower cost compared with deposits. In turn, this led to most Australian banks becoming more reliant upon wholesale funding to fund growth.

4.6 BANK FUNDING DURING THE GFC

The onset of the GFC, however, saw liquidity in capital markets substantially withdrawn. Financial institutions were largely unwilling to lend to each other and access to wholesale funds was severely limited and, when it was available, it was at a much higher cost.

As a result, many financial institutions globally experienced severe liquidity stress and were unable to meet their financial obligations as they became due, or fund new assets. Without sufficient available liquid assets, some financial institutions (mainly in offshore jurisdictions) were no longer able to operate.

Australian banks were not immune from the liquidity stress of the GFC. However, Westpac and other Australian banks were able to maintain good access to capital markets during this period. This was possible because:

- The diversity of banks' overall funding base meant they had no over-reliance on any single market;
- Banks' liquidity risk management frameworks meant the banks' short and long term refinancing needs were manageable;
- The introduction of the Australian Government Large Deposits and Wholesale Funding Guarantee ensured that banks were able to compete on a level-playing field with global issuers (for a fee) at a time when global investors were significantly risk averse. Since its introduction, the guarantee fees paid by Australian banks have provided approximately $4.4 billion to the Government without a single call on the guarantee; and
- The major Australian banks retained their AA ratings.

Maintaining access to wholesale markets during the GFC allowed many banks to continue to support customers. Westpac also supported smaller lenders with funding so they in turn could continue to operate.

1. RBA Bulletin June 2009.

The GFC highlighted the necessity of having a sound banking system able to perform its integral role as a provider of finance to the real economy.

4.7 STRUCTURAL CHANGES IN BANK FUNDING MODELS FOLLOWING THE GFC

The GFC caused a significant reappraisal of funding risks to the banking system from regulators, investors, rating agencies and bank management. Wholesale funding became more difficult and expensive to secure during the GFC, increasing liquidity risk for Australian banks.

In recognition of the need to have a more sustainable funding profile, banks took important steps to strengthen their balance sheets and improve liquidity management.

This has been achieved through a combination of initiatives, including sourcing an increased proportion of funding from household deposits (achieved largely through intense price competition), a reduction in the amount of short-term wholesale funding (especially from global markets) and a lengthening of the tenor of the overall wholesale funding portfolio. The major banks have also increased holdings of liquid assets.

These initiatives have significantly increased funding costs. But of greater importance has been the need to reduce liquidity risk and hence strengthen balance sheets, maintain credit ratings and meet new regulatory requirements.

4.8 DEPOSIT FUNDING SINCE THE GFC

In response to the liquidity stress experienced in numerous jurisdictions by banks during the GFC, Basel III has introduced liquidity reforms, primarily the LCR, aimed at improving the stability of bank liabilities and ensuring that banks have the necessary funding composition to withstand periods of acute liquidity stress. The LCR will be implemented in Australia by APRA through Australian Prudential Standard (APS) 210 effective from 1 January 2015.

Under the LCR, the quality of deposits will depend on their source and duration, and banks will be required to hold an amount of liquid assets that is dependent on the deposit's quality. The lowest quality deposits, for example those sourced from financial institutions and deposited overnight, will require banks to hold 100% of the value of the deposit in liquid assets. The highest quality deposits, including certain stable, household deposits, will require banks to hold 5% of the value of the deposit that matures over the next 30 days in liquid assets.

Effectively, this means that banks with more, higher quality deposits will have more funds available for intermediation. For example, for every $100 of short term but stable household deposits held by the bank, $95 is available to fund customer loans.

The ability of the banking system to access high-quality deposit funding is critical to its capacity to enable credit intermediation and in turn, economic growth.

4.9 THE BANKING SYSTEM NOW HAS A MORE RESILIENT FUNDING BASE

The structure of bank liquidity and funding profiles has also increased in importance in the determination of credit ratings. Credit ratings support Australian banks' ability to access wholesale funding at efficient market pricing, as they indicate to investors the level of relative risk associated with financial market investments.

Westpac is rated AA- by Standard and Poor's, Aa2 by Moody's Investors Service and AA- by Fitch Ratings Agency.

Westpac's efforts to shift its funding more towards customer deposits and higher cost longer-term funding has played an important part in maintaining its high credit rating.

The compositional changes in Australian bank funding have also resulted in a more resilient banking system and hence a stronger national economy. This will be a key factor in providing ongoing support to Australia's economic growth. Australia's banking system is now less reliant on wholesale funding overall (particularly short-term wholesale funding) improving the system's resilience against periods of extreme financial system stress.

Having consistent access to global capital markets plays a significant part in the ability of the Australian banks to support economic activity. Investor appetite has allowed the banks to maintain, and indeed slightly increase, their aggregate level of borrowings in global capital markets over the past four years.

Investor support for Australian issuers is evidenced by the position of US dollar investors. The GDP value of Australia represents 2.45% of the world economy,[1] while the share of US$ investment grade issuance from Australia was 4% in 2013.[2] And between 2010-12 Australian bank issuance was between 9-13% of global bank issuance.[3]

The breadth of investor support is also evidenced by the number of investors in Australian bank debt. Since October 2011, approximately 875 different investors have participated in Westpac primary debt offerings.

4.10 MAINTAINING THE ATTRACTIVENESS OF AUSTRALIAN BANKS IN CAPITAL MARKETS

The Australian financial system is always likely to have at least some reliance on wholesale funding in offshore markets if for no other reason than to diversify funding risk. For this reason it is important that the attractiveness of the Australian market in the eyes of foreign investors is maintained by ensuring:

- The Australian economy is on a strong and sustainable footing through the economic cycle;
- Australia has a AAA sovereign rating, which is supported by a strong and efficient financial system, including strong banks;
- A strong and stable financial system, with well-rated major banks;
- Support for, and the independence of, the central bank and banking regulator; and
- An open and transparent information flow with offshore investors.

4.11 THE CURRENT STATE OF THE FUNDING GAP FOR THE AUSTRALIAN BANKING SYSTEM

It is important that the funding available to the banking system is adaptable to support low, medium and high levels of growth. But there is a real risk the banking system will face a 'funding gap' that would inhibit its ability to provide finance to the wider economy.

PricewaterhouseCoopers (PwC) analysis[4] illustrates that the impact of strong credit growth and moderating household saving has previously led to a significant gap between the growth in banks' lending and the growth in their deposit base ('funding gap').

1. Tradingeconomics.com
2. Dealogic.
3. Citi.
4. PwC. 'Sustainably funding Australia's prosperity.' Annexure to ABA Submission to Financial System Inquiry.

The PwC analysis shows that in 1995 the level of bank lending was broadly around the same as bank deposits. By 2008, this gap had expanded to around $600 billion, and was essentially met through banks accessing wholesale funding markets. This gap remains at around $600 billion today.

Since the GFC, Australian households and the non-mining business sector have remained cautious, limiting their borrowing and holding relatively high levels of low risk financial assets (including deposits). This has resulted in annual credit growth averaging less than 4%, compared with average annual household deposit growth at 10.5% since mid-2007.[1] Banks have used customer deposits to fund asset growth and replace a portion of existing short-term wholesale debt. This has largely left new wholesale market borrowings to refinance long-term wholesale maturities.

In this environment, banks' wholesale funding requirements have been sustainable. Although the funding gap is broadly the same, it is a substantially lower proportion of banks' funding task. This has occurred in an environment with below trend economic growth and a (modestly) rising unemployment rate.

A key question is whether banks' funding requirements can be met when the economy again picks up steam.

4.12 THE IMPACT OF INCREASED CREDIT GROWTH ON THE FUNDING GAP

A consensus is rarely achieved on how the economy and its respective sectors will behave in the foreseeable future. There are a number of different saving and investment behaviours that agents of the economy may adopt in response to changing global economic conditions and changes to the structure of global financial sectors.

PwC analysed a range of savings and investment scenarios. Their work was based on an analysis of what level of credit growth was necessary to return to trend level economic growth. PwC found that:

- Economic growth between 1977 and 2009 was supported by average credit growth of between 1.5 to 1.7 times the growth in nominal GDP; and
- Post-GFC, credit growth has been weak from both households and business.

PwC noted that the Government has targeted a return to trend level of economic growth, which will need to be supported by the corresponding increase in credit growth.

PwC argues that the level of credit demand will differ from that needed during the recent phase of high level of resource investment, and that much of this credit demand will most efficiently be sourced through the banking system.

The three key scenarios in the PwC analysis are:

- **Low credit growth**: Annual credit growth remains around recent levels (4%), likely to mean that economic growth will remain below trend;
- **Medium credit growth**: Credit growth is 8% per annum, roughly double existing levels. The PwC modelling suggested that this is the level required to achieve trend GDP growth in the phase of the cycle where business investment in non-resource (and hence more credit intensive) sectors will be required. In this scenario, household demand for credit is likely to remain relatively subdued given the high level of household leverage; and
- **High credit growth**: Credit growth is 12% per annum, which is the level achieved consistently prior to the GFC when households were increasing leverage in response to a secular fall in interest rates. PwC considered that this is the least likely scenario.

1. ABS Cat 5232.0.

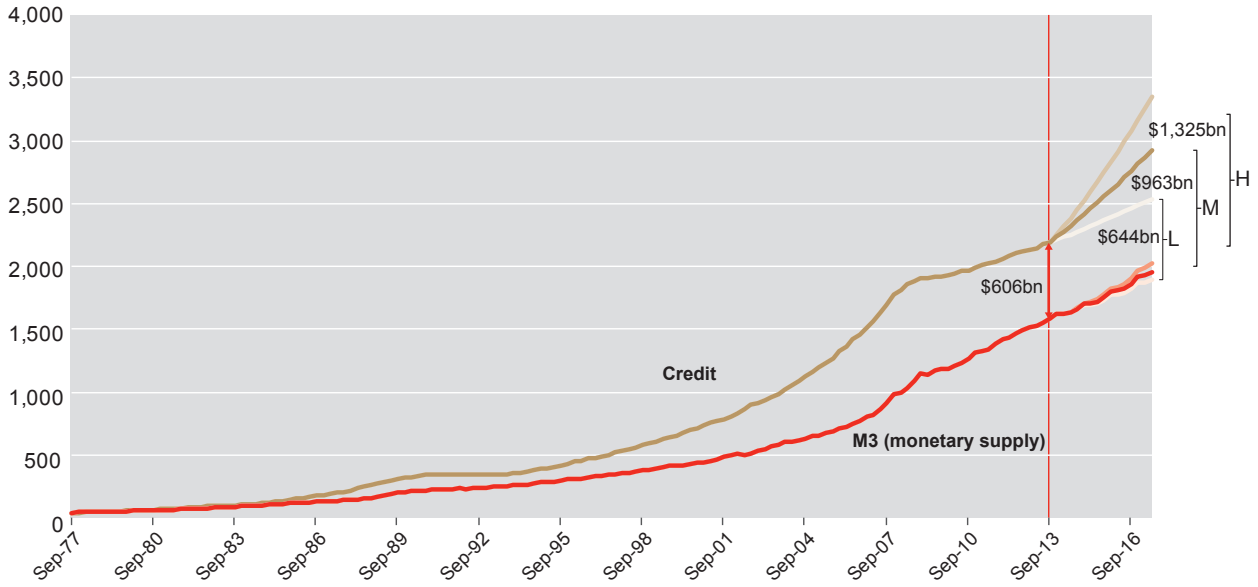
CHAPTER 4
FUNDING AUSTRALIA'S FINANCIAL SYSTEM FOR ECONOMIC GROWTH

In the low growth scenario, PwC projected credit demand moving in line with deposits. The magnitude of the funding imbalance (the difference between bank lending and bank deposits) remains relatively stable, moving from PwC's estimated level of $606 billion to $644 billion. Banks would be able to bridge this gap in a sustainable manner through the wholesale markets.

Under the medium and high growth scenarios, PwC sees the magnitude of the imbalance growing and, therefore, the reliance of banks on the wholesale market to fund this imbalance increasing. In both scenarios, demand for credit and deposits grows more quickly than in the low growth scenario, but credit also grows considerably faster than deposits.

The result is that the magnitude of the imbalance increases to approximately $963 billion and $1,325 billion, respectively. This is wider than the levels seen during the market disruptions of 2008 (although below the level of 2008 when measured relative to the size of the economy).

Figure 4.2 – Magnitude of system imbalance between credit demand and monetary supply (A$bn)[1]



The low, medium and high-growth scenarios in the PwC analysis are not the exclusive ways savings and investment decisions in Australia will evolve. But they do highlight that under various reasonable economic conditions, the financial system would face a substantial funding task to meet demand for credit.

It is also important to note that under the medium and high-growth scenarios, the PwC analysis assumes that superannuation and insurer deposits, driven by SMSFs, will be the strongest growing class of deposits. Should this allocation of SMSF assets not occur, the funding gap will be larger.

The funding gap and offshore wholesale funding

The ability for Australian banks to increase their borrowing capacity to meet such a funding task in offshore wholesale markets is uncertain. Borrowing in offshore wholesale markets relies on positive sentiment and investors maintaining a favourable view towards the Australian economy, both in an absolute sense and relative to other jurisdictions.

1. PwC. 'Sustainably Funding Australia's Prosperity.' Annexure to ABA Submission to the Financial System Inquiry. Based on APRA, RBA and PwC Analysis.

In recent years, Australia's relatively strong economic and financial performance has increased its attractiveness to foreign investors. However, as the rest of the world recovers, the attractiveness of other jurisdictions relative to Australia will improve and the ability for Australian banks to attract investment may be challenged.

Of course, price can always be a tool used to adjust for a change of investor sentiment. But there are periods (such as during the GFC) when funds were not available to borrowers at any price and borrowers were forced to rely on central banks for emergency liquidity. Overall, the unpredictability of the supply of wholesale term funds (particularly from offshore) makes it a less reliable source of financing over the medium to long term.

Reliance upon wholesale funding to fill any significant funding gap will be particularly difficult for smaller, lower rated financial institutions. Larger, more highly rated financial institutions are able to source funds in capital markets more easily and at lower rates, owing to their higher credit rating, ability to provide liquidity and scale.

Therefore, reducing the reliance of the Australian banking system on offshore wholesale funding will help strengthen the entire system to both better support the next upswing in credit growth and to withstand unexpected financial developments.

Encouraging a higher proportion of national savings to remain within the domestic banking system mitigates the risk of undue reliance on global markets. A clear advantage is that a deeper pool of domestic funding will become available to support loans and investments for Australian consumers and businesses, and overall economic growth. A deeper pool of domestic savings does not favour any one player in the banking system.

It should be noted that individual banks' risk appetites for refinancing risk is also an important factor. Westpac's risk appetite reflects its prudent approach to risk management and its desire to ensure a very high degree of resilience against market disruption. Refinancing risk is managed within a board approved limit structure, taking into account both short-term and long-term debt maturities and Westpac's capacity to replace that funding in the future.

4.13 PROPOSED LONGER-TERM FUNDING SOLUTIONS

It is important that Australia's financial system is able to support optimal economic growth in all environments – including the low, medium and high credit growth scenarios discussed in the previous section. To achieve this, the banking system's access to high quality funding sources is critical.

One of the key causes of the expanding funding gap in the banking system has been the impact of government policies. In particular, the growth in household bank deposits has been impacted by government retirement income policy (compulsory superannuation), as well as the preferential tax treatment that has favoured superannuation, equities and property over bank deposits and fixed income products.

In Westpac's view, the primary long-term solutions for increasing the sources of higher quality funding are:

- Equalising the tax treatment between bank deposits and other competing savings options; and
- Encouraging the investment of superannuation funds in bank deposits and fixed income securities.

Other complementary measures for increasing the existing funding base for the financial system include supporting the growth of the securitisation market, encouraging a deeper Australian corporate bond market and broadening the interest withholding tax exemption.

Diversifying the existing funding base is also important for improving the competitive landscape through enhanced funding opportunities. As discussed in Chapter 2, for example, access to funding is an important factor for contestability, and therefore competitiveness, in markets.

4.13.1 Tax equalisation of bank deposits

The Henry Review considered the tax treatment of various types of savings income, including interest income from deposits. The tax treatment of deposit interest income is an important issue for the banking system, as household deposits are a source of higher quality funding.

The Review noted that current arrangements lead to personal tax outcomes that vary widely depending on the form of saving undertaken. Interest income on savings has the least favourable tax treatment. The entire return, including inflationary gains, is included annually in taxable income, generating an effective marginal tax rate on the real return greater than the statutory marginal personal tax rate.

In contrast other assets are treated more favourably from a taxation perspective, for example:

- Shares benefit from the capital gains tax discount, with domestic shares also benefitting from dividend imputation;
- Rental properties benefit from the differential treatment of gains and losses, driven by the capital gains discount that can potentially be exacerbated by high gearing levels;
- Returns from owner-occupied housing are untaxed, giving rise to a zero effective tax rate; and
- For superannuation, the ability to make contributions out of pre-tax income (rather than post-tax income), can result in a negative effective marginal tax rate.

The Review concluded that a move to a broad 40% discount for personal income from bank deposits, bonds, rental properties and capital gains and for certain interest expenses would provide more consistent tax outcomes and support a more productive allocation of savings. In recommending the broad 40% discount, the Review noted further consideration would be required regarding the boundaries between discounted and non-discounted amounts, and transition to the new tax treatment.

The Review stated that the main forms of lifetime savings for most Australians – superannuation and owner-occupied housing – should continue to be treated more favourably than other asset classes.

In the context of the banking system, a more equal personal tax outcome for bank deposit interest income would encourage a greater level of household bank deposits, therefore increasing this source of higher quality funding for bank intermediation.

Westpac recommends the Inquiry considers measures for tax equalisation between bank deposits and other competing savings options.

The specific nature of these measures should be considered in the Government's tax white paper process.

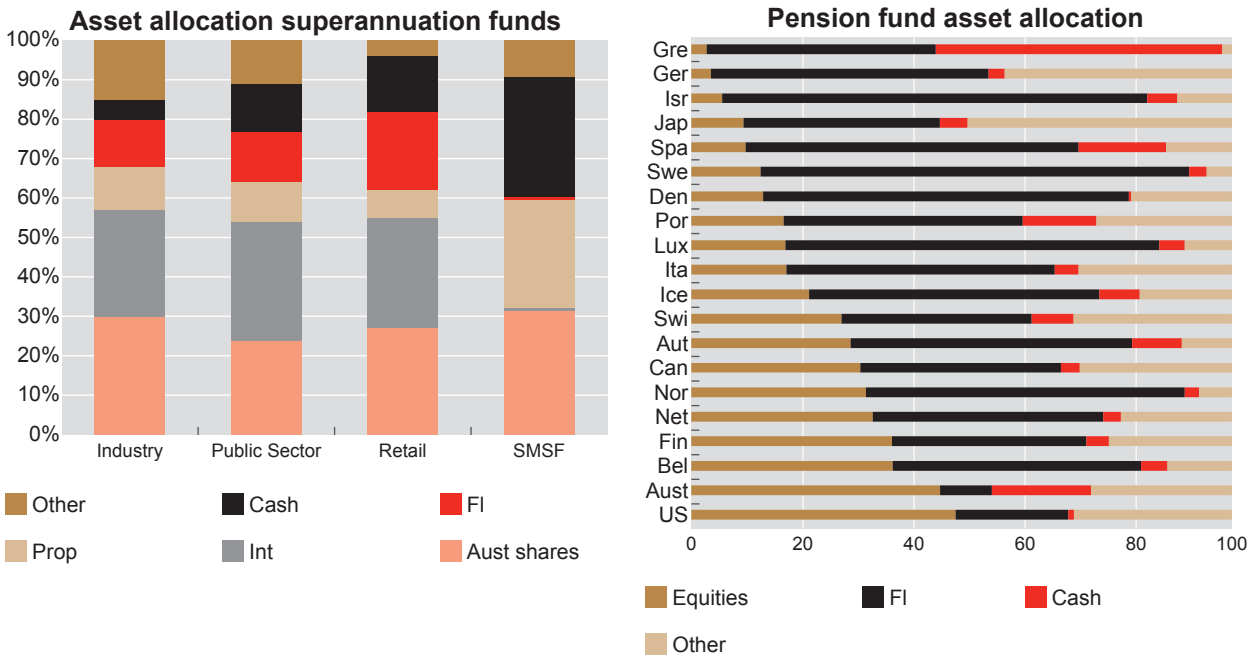
4.13.2 Superannuation

Australia's superannuation sector is already large, and it is expected to grow strongly over the next 20 years. Total superannuation assets are predicted to reach $7.6 trillion by 2033. As a result, the impact of superannuation asset allocation decisions has significant implications for the wider financial system and economy.

The current asset allocation for superannuation funds differs between industry, retail, public sector and SMSF. The table below outlines their current asset allocations. The standout features include:

- Low level of allocation towards fixed income across the different forms of superannuation;
- High allocation towards cash by SMSFs;
- High allocation towards equities across the different forms of superannuation funds; and
- By contrast to professional fund managers, SMSF holders allocate a very small portion of funds to international investments.

Figure 4.3 – Australian and global superannuation and pension asset allocation



Sources: APRA, ATO, OECD, Westpac calculations

By global standards, the allocation towards domestic fixed income in Australia is low and the allocation towards equities is high.

The pool of superannuation savings will continue to grow, supported by tax incentives and compulsory employer contributions. While some of these savings will flow into the banking system through deposits by SMSFs and other superannuation investment, these flows are generally considered lower quality sources of funding by regulators and therefore contribute less to funding ability than direct household deposits.

The direct investment by households into superannuation means less household investment is directed to bank deposits and fixed income securities. This framework is a major component of the bank 'funding gap,' which is expected to increase as superannuation as a proportion of total savings grows.

Encouraging investment of superannuation into the banking system

There is an opportunity to examine options to encourage the investment of superannuation in domestic bank deposits and fixed income securities. We would encourage the Inquiry to examine these options. One such option relates to the 'retirement phase' of superannuation, the point where retirees are able to access their superannuation savings.

Currently, retirees are able to take their funds in a lump sum, and theoretically, retirees are eligible for the pension if those funds are depleted. Retirees are also faced with the 'longevity risk' challenge, that is, that they may outlive their income stream.

An option for overcoming these challenges is for the Government to encourage a proportion of funds at retirement to be invested into products that provide regular income, such as bank deposits and fixed income products, or products that provide similar properties such as annuities. These products would be designed to meet the high-quality funding requirements for banks and be designed to 'qualify' as an encouraged investment for retirees. They could also help address longevity risk in retirement.

From a banking industry perspective, a move to a level of encouraged investment at the retirement phase would have the benefit of increasing the demand for bank deposits and fixed income instruments.

Further, this approach could have the benefit of reducing pressure on government budgets by reducing claims on pensions.

4.14 COMPLEMENTARY FUNDING MEASURES

4.14.1 An improvement in the securitisation market

Securitisation is an important way in which non-bank lenders are able to compete with larger, more highly-rated banks. There is a correlation between the availability of this funding source and the ability of smaller lenders to compete (as discussed in Chapter 2).

Globally, there has been a gradual return of the securitisation market over the past year reflecting an improvement in investor risk appetite. The market has returned particularly strongly in Australia. As part of the Basel III reforms, improvements have been made to the institutional structure of the securitisation market.

These institutional improvements, together with a cyclical revival of investor risk appetite, should see securitisation help fill part of the Australian economy's funding challenge. The significance of this contribution will depend on a range of factors, including investor demand, the underlying performance of the property market and comparative pricing for other fixed income products (including bank debt).

The Inquiry may wish to consider further options to support the growth of the securitisation market. These include:

- Allowing Australian securitisation issuers access to a wider range of securitisation funding techniques such as master trusts, date based calls[1] and the elimination of the 20% holding limit on instruments;[2]
- Lobbying for reciprocal international central bank repo treatment, that is, Australian asset-backed securities and covered bonds becoming 'repo-eligible' at the Federal Reserve, European Central Bank and Bank of England which would increase international investor demand; and
- Minimising, as far as possible, costs and uncertainty associated with holding and issuing securitisations. This includes the timely introduction of regulation and prudential standards (the industry has been awaiting

1. Date based calls would provide issuers with greater flexibility as to the maturity date of securitisation issues (currently a bank can only redeem a securitisation once it has reduced to 10% or less of its original size), enabling issuers to potentially appeal to a wider investor base as well as reduce the cost of issuance.
2. By restricting banks to holding no more than 20% of their securitisation instruments this limits: a) the types of assets that banks can securitise to mainly retail, granular assets; and b) the types of structures that banks can issue. Removing this restriction would enable banks to further diversify their funding and create greater flexibility in their ability to access term funding.

the introduction of a revised prudential standard for over two years). A further option is not increasing the capital charges associated with banks holding securitisations or compliance costs (such as the asset-by-asset reporting required by the RBA).

4.14.2 Corporate bond market

An expansion of the domestic corporate bond market provides several benefits to the financial system including:

- Offering diversification for corporate borrowers, particularly those seeking longer tenors in their funding mix. This creates a more stable platform for future investment;
- Potentially reducing Australia's reliance on offshore markets by providing an additional domestic funding source;
- Providing an additional asset class to satisfy demand for fixed income investments; and
- Supporting competition in the financial system through diversifying funding sources.

Two changes were announced to the retail corporate bond market by the Federal Government in 2013:

- Introducing a shorter, simplified[1] two-part prospectus regime for 'simple corporate bonds'; and
- Easing the liability burden on directors.

In time these changes should be positive for corporate bond issuance targeted at the retail market, however it should be noted they have not yet been passed into law. Westpac supports the introduction of these measures, and others such as improved investor accessibility (e.g. online bond trading portals).

Tax disincentives for investment in corporate bonds versus other asset classes would also need to be considered as part of steps to increase demand for corporate bonds.

An expanded domestic corporate bond market would complement the long-term funding solutions of equalising the tax treatment of bank deposits and encouraging superannuation investment into bank deposits and fixed income securities.

While the US corporate bond market (which is a key funding pillar for the US economy) has featured a pool of between 500-600 investment grade issuers each year for the last three years (excluding financial institutions), Australia's market has ranged between 30-50 issuers in the same period.[2]

Therefore there is an inherent limitation in the domestic market's capacity to provide diversity and volume of investment grade issuance for investors and hence it is unlikely to offer the size and breadth to become a significant long-term solution to broad-based credit provision.

4.14.3 Interest withholding tax

There is an existing exemption from withholding tax on interest paid to non-residents on certain publicly offered debentures (under section 128F of the *Income Tax Assessment Act 1936*) however this exemption does not cover all sources of funds.

A broad interest withholding tax exemption for interest paid by Australian financial institutions to non-residents should facilitate access to more diverse funding sources.

1. A 'simple' corporate bond was defined as one with relatively few complex features such as having no embedded options, a maturity of less than 10 years and an issuance amount greater than $50m.
2. JP Morgan analysis, 2014.

Interest withholding tax is ultimately a liability of the non-resident recipient of the interest paid by an Australian borrower. However, as a matter of commercial practice, Australian financial institutions bear the cost of any interest withholding tax by grossing up interest payments to non-residents. This increases the cost of capital for Australian financial institutions raising funds offshore.

The Henry Review recommended that interest withholding tax should not apply to interest paid by Australian-based financial institutions to non-residents. This should facilitate access by Australian financial institutions to more cost effective and diverse funding sources.

4.15 FUNDING CHANGES MADE SINCE THE GFC

A number of regulatory and institutional changes have been made since the GFC that have improved the financing of the Australian economy, and assisted in mitigating Australian banks' funding task. The changes have improved the sustainability and resilience of the financial system, but they are unlikely to ever provide a source of funds to fill a bank funding gap that may emerge in a high credit growth scenario.

4.15.1 Covered bonds

Covered bonds are less sensitive to financial market fluctuations than traditional bank wholesale funding sources due to their high credit rating. They have enabled Australian banks to diversify their investor base and increase the maturity of debt issued at economical levels, reducing funding risk.

An increase to the cap on the covered bond pool from 8% to 10-15% would be a positive expansion to the funding available to banks. However, covered bonds issuance is more useful as a contingent funding tool (i.e. for use in difficult market conditions) than a primary funding source.

4.15.2 Committed Liquidity Facility

From 1 January 2015, a CLF will be introduced to address the shortage of qualifying AUD high quality liquid assets in Australia. This enables Australian ADIs to meet the LCR requirement (discussed in Chapter 3). The CLF ensures that ADIs (that are subject to the LCR) will have access to funds, and therefore continue to meet their obligations and have capacity to lend, in an acute stress scenario.

To use the CLF, APRA and the RBA have stated that an ADI must take all reasonable steps to increase duration of liabilities and maximise reliance on stable sources of funding to the greatest reasonable extent. The size of the CLF granted will be determined by APRA.

The CLF is a positive tool for assisting banks to fund customer activity, however the extent of its use is subject to regulatory discretion. If there are large differences between the level of the CLF requested by individual ADIs, and that granted by APRA, this would result in ADIs applying further funds to the purchase of high quality liquid assets rather than to lending activity.

4.16 FINANCIAL CLAIMS SCHEME

The Financial Claims Scheme was a measure introduced by the Government during the GFC. It was intended to have minimal impact on the industry given the low likelihood that there will be a major call on the scheme.

In particular, it was introduced as a post-funded scheme. That is, the Government would pay out depositors affected by a bank failure and then seek to recover the funds from the assets of the failed institution. If there are insufficient assets in the failed institution, the Government can impose a levy on surviving institutions to recover any shortfall.

Westpac does not support a pre-funded scheme. Due to the high loan to deposit ratio in Australia, Australian depositors are well covered by high quality assets (largely residential mortgages). In the event of bank failure, it is likely that wholesale debt financiers will be most at risk of loss.

Furthermore, any pre-funded levy for the scheme would be an additional cost on banks that is likely to be passed on to depositors. This would erode customer savings and further reduce the attractiveness of bank deposits relative to other classes of assets.

4.17 CONCLUSION

It is important that the financial system is able to support the optimal level of economic growth in all environments. Evidence indicates that, in certain likely credit demand scenarios, a gap will emerge in the banking system's ability to fully fund the needs of Australians. It is unlikely this gap could be filled by market-based options. The key to addressing this issue is to enhance the amount of high-quality funding available to the banking system.

Access to necessary levels of high-quality funding is critical to the sustainability of the financial system and its ability to best support Australia's growth.

Westpac GROUP

Recommendations

Westpac recommends the Inquiry:

- Considers measures for tax equalisation between bank deposits and other competing savings options; and
- Considers options for encouraging the investment of superannuation into bank deposits and fixed income securities.

CHAPTER 5
ENHANCING AUSTRALIA'S PRODUCTIVE CAPACITY: SUPPORTING SMEs

5.1 INTRODUCTION

Westpac believes Australia has entered an important new phase in our economic growth that is defined by changes in demographics, technology, consumer behavior and extraordinary global forces.

A major challenge for Australia's policy makers in recent years has been how to respond to these changing forces. The question of how best to support new and dynamic industries to fill the gap created by the reducing economic and business activity of traditional sectors of the Australian economy has increasingly been an area of investigation.

To this end, it is important that the sectors of the economy that can most add to the nation's productivity are receiving the financing they need.

SMEs make a significant contribution to the Australian economy as a key source of economic activity, employment and production. In the 12 months from 2010 to 2011 the SME sector as a whole contributed to more than half (57%) of private sector economic activity, valued at $530 billion.[1] It is estimated that the sector amounts to half of all employment and one third of total production in the non-financial private sector.

A healthy SME sector will be vital as Australia continues to seek to produce highly-skilled jobs, in a world that is increasingly influenced by the development of the 'knowledge economy' and the fast pace of technological change. For example, the SME sector currently undertakes a high level of innovation. In the 12 months to 2011, approximately 40% of SMEs were 'innovating firms'.[2]

SMEs' ability to access finance is an enabler of business start-up, expansion and growth. Both debt and equity finance can provide an appropriate source of working and growth capital for SMEs. Debt finance is appropriate where responsible lending standards can be met and debt serviceability (creditworthiness) is achievable.

For the small proportion of SMEs that seek external finance, debt is preferred over external equity. Research[3] suggests that in general, the majority of SMEs are successful in applying for debt. Nevertheless, Westpac believes that it is important to examine whether there are opportunities to further enhance SME access to debt finance in a manner that is consistent with principles of responsible lending. Westpac suggests that industry and Government work together to examine appropriate measures, including, for example, increasing the knowledge and capacity of SMEs to make successful credit applications.

However, there is likely to remain a small subset of SMEs where the provision of debt finance would fall outside appropriate credit risk frameworks or responsible lending criteria. Equity may be an appropriate source of finance where a lack of information on trade and credit history cannot be overcome and a SME does not have an adequate source of security. This type of finance is expected to be particularly important for a growing number of start-up SMEs. Over time, it will likely also support debt finance to the SME sector as additional equity may improve a SME's creditworthiness and access to debt finance.

Currently, there is both limited demand and underdeveloped private equity, venture capital and crowdfunding markets in Australia. The enhanced provision, and knowledge, of these forms of financing could help foster the SME sector by ensuring that even SMEs that do not meet lenders' requirement can still obtain finance on the basis of a solid business concept.

Therefore, Westpac recommends that a taskforce be established to examine opportunities to develop these alternative financing options in Australia. This may include examining the role the banking sector has to play in facilitating connections between investors and SMEs. A joint approach by Government and industry to assist SMEs effectively present themselves as investable opportunities could also facilitate the sector's development.

1. Deloitte Access Economics. Connected Small Business: How Australian small businesses are growing in the digital economy. 2013. p.3.
2. Defined as a firm that introduces a new form of production (process or product) within a given time period. Department of Innovation, Industry, Science and Research. Key Statistics Australian Small Business. 2011. p.63.
3. Deloitte Access Economics. Access to capital for small and medium-size enterprises: Report commissioned by NSW Business Chamber 2013.

5.2 DEFINITION OF AN SME

Westpac believes the lack of a standard definition of a "small business" or "SME" is an inhibitor to comprehensively assessing the current state of Australia's SME sector, including issues facing the sector.

A consistent and universal definition would assist with the collection of industry-wide quantitative data on SME lending volumes. This would be valuable in supporting analysis of SME access to debt finance. In recognition of this, Westpac is actively involved in industry discussions on a business lending data standard. APRA and the RBA will be engaged by the Australian Bankers' Association to progress this further.

Westpac would support a process in which the Government and industry collaborate to develop consistent definitions of business types for the SME sector. This definition could also identify 'small business' as a sub-sector of SME, as distinct from 'micro' and 'medium' businesses.[1]

5.3 WESTPAC GROUP'S SUPPORT FOR SMEs

Westpac provides a range of financial and non-financial support throughout an SME's lifecycle to help them manage and grow their business. These include:

- Transaction services and the provision of payment systems, including smartphone based apps;
- Secondary support services, including the provision of advice and technology to support business functionality;
- Risk management products such as insurance and foreign exchange; and
- Debt financing.

Growing SME banking business is one of Westpac's strategic priorities. Westpac has approximately 950,000 SME customers across our brands including: Westpac, St.George, BankSA, Bank of Melbourne, RAMS and BT Financial Group (BTFG). Westpac views the banker-SME relationship as central to our ability to provide tailored services to customers. There are a number of initiatives already underway which build on the importance of this relationship.

Across Westpac's businesses there are specialist bankers available to assist SME customers. For example, Local Business Bankers (LBBs) are based in Westpac branches and provide dedicated relationship management to a portfolio of around 150 SME customers each. These bankers have a detailed understanding of the local community and business conditions. To streamline loan approvals for SME customers, the number of LBBs with the discretion to approve loans on the spot is increasing. Devolving decision making to frontline bankers is viewed as a key process improvement for our SME customers.

The branch footprint is complemented by mechanisms to increase remote access by business owners to bankers. For example, the 'Connect' services enable SME customers to obtain specialist advice from bankers via video-conferencing facilities in branches. This is particularly important in ensuring that SME customers in rural and regional areas are able to access high-quality, specialist bankers at times that suit them.

Westpac's support for SMEs goes beyond a relationship-based approach to banking, to include:

- Provision of cash flow tools such as CashScan™[2] and a breakeven tool;[3]
- Assistance to leverage technology (which is recognised as an important source of growth and efficiency for SMEs).[4] For example, Westpac's research demonstrates that a large number of SMEs have not yet embraced the benefits of digital technology. Westpac continues to work to address the digital divide and support customers to engage with technology solutions for their business[5];

1. The Parliamentary Joint Committee on Corporations and Financial Services (2011) suggested consistent definitions of these three categories would assist statistical analysis of the health of the SME sector and promote more informed policy making.
2. Produces an assessment of the working capital cycle of a business and informs of "blockages" (or where "hidden cash" lies in a business).
3. Helps businesses understand their breakeven point (costs and revenue equal), to understand how many extra sales are needed or how much additional production is required to cover additional costs.
4. For example websites to gain exposure and leverage the growing use of online shopping, digital solutions for administrative and operational activities e.g. accounting, book-keeping and payroll, use of social media, development of Business to Business (B2B) services and online banking services and payment facilities.
5. As at October 2013, 59.7% of Westpac SME customers were digitally active (i.e. have logged onto an online banking platform over the past 90 days) and 53% of Australian small businesses did not have a website.

- Simplifying the finance application processes;
- Simplifying and tailoring product offerings (for example by providing bundled products and discounts for holders of multiple products);
- Providing specialist advice. For example, Westpac continues to develop partnerships with other specialist organisations to provide additional services that help our business customers succeed such as free legal or tax advice;
- Greater expenditure in delivering a more flexible service to meet the needs of our SME customers, such as the introduction of 24 hour 7 day a week automated branches, which are ideally suited to many SME customers who do their banking after hours; and
- Conducting research, such as the Westpac-Melbourne Institute Small Business Index.

5.4 ISSUES FACED BY SMEs

The ability of SMEs to access finance has been a consistent point of discussion globally following the GFC. In Australia, existing qualitative survey results on small business finance vary. However, the figures demonstrate that access to finance is not a primary concern for the majority of SMEs. A Deloitte Access Economics (DAE)[1] report notes that "access to capital is not a pressing problem for a large majority of SMEs". This is consistent with Westpac's research. For example, the first quarterly results of the Westpac and Melbourne Institute Small Business Index found that the three top issues for small businesses are competition, the economy and regulation.

5.4.1 Access to external finance

Pecking order theories[2] suggest that SMEs prefer internal to external finance and, where outside external funds are necessary, debt is preferred.[3] However, equity provides another important external source of capital.

In general, bank intermediated debt is the main source of credit for SMEs as opposed to trade credit[4] or debt capital markets. A range of intermediated SME debt facilities are available including short and long term lending, working capital and equipment finance.

It is important to note that most small businesses do not borrow. According to Australian Taxation Office (ATO) data, more than 60% of small companies did not have any debt in the 12 months to 2010. This aligns with Westpac's experience; currently only one-third of Westpac's existing SME customer base have a business debt facility.

While it is hard to identify the source of funding for the remainder of customers, some SMEs may make use of personal resources, self-fund from cash flow or access other forms of finance.

Survey data suggests that, "of the small businesses that choose not to seek external finance, only a small proportion attribute this to an expectation that it will be difficult to obtain."[5] This has led the RBA to conclude that "in general, internal equity funding and existing debt facilities meet small business' needs."[6]

1. Access to capital for small and medium-size enterprises, Report commissioned by NSW Business Chamber 2013. p.27.
2. The theory states that companies prioritise their sources of funding, with a preference for internal equity, then debt and then external equity as a 'last resort'. Myers, S and Majluf, N, 1984, 'Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not', Journal of Financial Economics, 13 (2), pp. 187-221.
3. RBA. Submission to Parliamentary Joint Committee on Corporations and Financial Services. Access for small and medium business to finance. 2010. p.1.
4. This is defined by the RBA as credit from a SMEs trade suppliers i.e. when it obtains inventory, equipment and services without immediate payment. Small Business Finance Roundtable, Small Business Funding in Australia, p.20.
5. Matic. M. Gorajek. A, Stewart, C. Small business funding in Australia. 2012. p.10.
6. Small Business Finance Roundtable, Small Business Funding in Australia, May 2012. p.16.

5.5 DEBT FINANCING

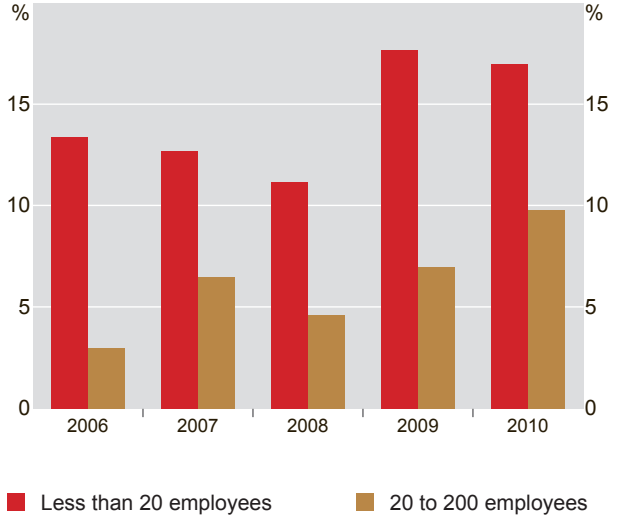
5.5.1 Recent experience in the SME lending market

During the GFC and the post-GFC period, Westpac has continued to lend to the SME sector. Westpac made no major changes to key credit policies relating to debt service cover, interest cover, LVRs (except for commercial property) or other credit policies. Westpac does not have a limit on the total amount of money made available for SME lending. As a result, Westpac's approval rate has ranged above 80-90% since 2009.

This is consistent with estimates by DAE, which suggest that approximately 90% of SMEs do not have a problem accessing finance,[1] and RBA estimates of the proportion of unsuccessful SME credit applications (shown in the chart below).

Figure 5.1: Declined credit applications[2]

Per cent of firms in size category that sought finance*



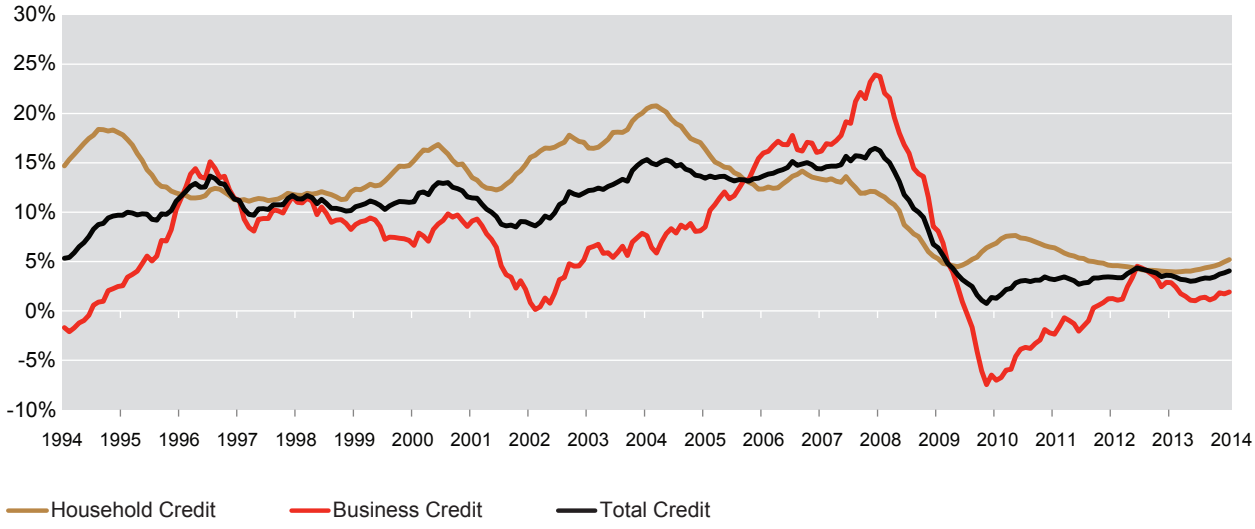
* Data are for firms who responded in all five years
Source: ABS Business Longitudinal Database

While Westpac continued to make finance available to SMEs, there was a general slowdown in small business credit growth during the GFC. Post GFC, growth has improved, however it remains subdued. Business confidence in the Australian economy will continue to play a role in the appetite of SMEs to seek external finance. A reduction in demand for finance by business and consumers has been the major driver of slowing credit growth in Australia. This is evident in the chart below.

Chapter 5

1. NSW Business Chamber, Small Business Access to Finance, 2013. p.7.
2. http://www.rba.gov.au/publications/workshops/other/small-bus-fin-roundtable-2012/pdf/02-small-bus-funding-aus.pdf

Figure 5.2: Credit growth (annual)



Source: RBA

During the GFC almost all non-major bank lenders either withdrew from the Australian market entirely, or curtailed their lending substantially. This was largely driven by their inability to source funding. Solutions to this issue were previously discussed in Chapter 4 (Funding).

Small businesses which, prior to the GFC, were obtaining their finance from non-major bank lenders were generally higher risk borrowers who did not meet the lending standards of the major banks. As a result a number of SMEs may have found their finance options constrained.

In the post-GFC era lenders have entered the market to replace some of the market gap left by the exit of smaller lenders. Indeed, the RBA notes that, despite structural changes in the lending market small businesses in most industries were able to access credit throughout the financial crisis.[1]

The situation in Australia is in stark contrast to other developed countries such as the UK and US where banks have constrained lending to the SME sector with significant flow on effects to economic growth and employment. Deleveraging of balance sheets to increase holdings of relevant capital components has been a key mechanism for overseas banks to comply with international capital regulations. This has resulted in a decline in the amount of SME lending, particularly in Europe. For example, in France, Italy and Ireland, SME lending has declined by about 50% from its peak.

The conditions in other jurisdictions have led some governments to undertake major interventions in the market to support SME lending. For example, the UK Government has put in place the Funding for Lending scheme which allows financial institutions to borrow from the Bank of England at cheaper than market rates for up to four years.

Other initiatives in the UK to increase lending to SMEs include the establishment of a Business Bank to be fully functional by the third quarter of 2014. Perceived credit risk has also been addressed through the provision of government guarantees as part of the Enterprise Finance Guarantee loan scheme.

Westpac believes that the Australian experience does not call for such measures to be introduced here.

1. RBA. Submission to Parliamentary Joint Committee on Corporations and Financial Services. Access for small and medium business to finance. 2010. p.1.

5.5.2 Factors influencing access to debt finance

In Westpac's view, there is not currently systemic market failure in the sense of a class of SME borrowers being unable to access debt finance. Not all businesses should access debt finance. Furthermore, as the NSW Business Chamber's report into Small Business Access to Finance notes:

"Lenders cannot – and should not – lend to everyone, so the economic implications of difficulties with SME access to finance depend on the reasons why they were refused".

It is therefore worth considering factors which have been suggested may affect a small proportion of SMEs' access to debt finance. Suggested reasons include:

- Lack of knowledge and capacity of SMEs;
- Lending standards for SME customers;
- The availability of information to support credit applications;
- Impact of the regulatory framework on SME lending;
- Pricing of SME credit facilities; and
- Life cycle factors, in particular for start-ups.

SME knowledge and capacity

Business acumen and financial literacy is vital to ensure the ongoing viability and success of SMEs. It is also likely to improve the quality and completeness of SME credit applications which make them more likely to be approved as bankable propositions. In recognition of this, Westpac established the Davidson Institute in 2011 as a complete educational resource to help all Australians, including SME customers, to make confident financial decisions. A range of support is provided to business, including courses on: developing business plans, managing business growth while sustaining cash flow, understanding financial markets and trade, succession planning, import/ exporting, recruitment and employee management.

There are further opportunities for the industry and Government to collaborate to increase SME awareness of the financing options available to meet their business needs, improve SME expertise in applying for finance and increase the confidence of SMEs to secure finance. The European Union's Enterprise Europe Network (a central portal of information to assist SMEs) is an example that could be developed in Australia.

Lending standards

Lenders have to make an assessment of the risk of lending to a particular SME and decide the terms, collateral and pricing of the loan accordingly. Behavioural and quantitative factors are an important part of this assessment.

Westpac's credit decisions are based on long-standing underwriting standards, which include capacity to repay the loan through cash flow (debt serviceability), past customer repayment and credit history, capabilities and track record of the business owners and management, and security offered.

In Westpac's experience, SME applications for credit are declined mainly due to:

- Failure to demonstrate debt serviceability;
- Poor internal or external credit behaviour; and/or
- Insufficient equity or security.

Failure to demonstrate debt serviceability may be caused by:

- Cashflow uncertainty or projections (lack of historical financial information to support a finance request); or
- Uncertainty regarding cashflow management.

Declined applications are a natural result of the combination of responsible lending principles and sound risk management, and are not an inefficient feature of the financial system. Westpac does not believe that arbitrary relaxation of lending standards should be used to close the gap.

However, some of the factors which result in a decline of an application may be overcome through improving the quality of information available to lenders.

Information

Information on a potential borrower, including their credit history, is critical for lenders to make effective credit decisions. For example, many start-up SMEs have difficulty in demonstrating creditworthiness due to "information gaps." Measures that could improve the level and quality of information that lenders have to assess credit risk have the potential to enhance SMEs' access to credit, even where there is no collateral available or security is less tangible.

Historically, lenders relied heavily on making credit decisions based on information obtained through the banker-borrower relationship, and responsibility sat with the individual who managed and knew the prospective SME borrower. Westpac has undertaken significant investment in building close relationships with our SME customers to ensure credit decisions incorporate the best information available. However, this could be supplemented by Government measures to provide more information to lenders.

Enhancing lenders' access to business information from Government and regulator sources (such as the ATO and ASIC) could facilitate SME access to credit. Privacy issues would need to be addressed under such an arrangement. Nevertheless, there are existing mechanisms that could mitigate these concerns, including opt-in arrangements.

Real time access to certified Business Activity Statements (BAS) could enable dynamic assessment of credit risks for start-up businesses on a quarterly rather than an annual basis. This could include unsecured lending based on certified cash flows, where credit history is not available.

Westpac suggests that the Government form a working group consisting of representatives of APRA, ASIC, ATO and the banking industry to examine policy options for expanding lenders' access to Government sources of credit-related information.

Regulatory framework

There has been much discussion globally about the impact of prudential regulation on SME lending, particularly whether regulatory capital requirements:

- Constrain banks' willingness and ability to lend to SMEs; and/ or
- Disproportionately favour residential mortgages over small business lending (wholly secured by a residential property).

The discussion on the first point often draws on the experience of overseas jurisdictions which have seen a marked decline in SME lending, primarily due to lack of capital. Conversely, Australian banks have adequate capital. For example, Westpac organically generates capital through ongoing profitability and has ready access to capital markets to source additional capital when required.

As a result of this capital position, there is no incentive to reduce risk weighted[1] assets (RWA) through divestment of loans to SMEs. The impact of prudential regulations in Australia has therefore been significantly different to the experience of countries like the UK.

The introduction of Basel II in 2007 brought lower capital requirements for SME, as well as other forms of lending. More recently Basel III reforms have included more stringent approaches to managing liquidity risk and higher capital ratios, which does reduce the extent of the benefit gained under Basel II. For example, pre-crisis under Basel II, the minimum capital requirement was 8% of RWA. Banks were able to meet these capital requirements in part with less costly forms of capital (such as subordinated debt and hybrid securities), whereas Basel III has shifted the requirements far more to common equity. While this increases the cost of providing credit across all types of lending for Australian banks, the major banks remain well-capitalised and there is no evidence that these regulatory reforms are constraining the supply of credit to SMEs in Australia.

While prudential regulation in the Australian context has not impacted lending appetite, it is one of the factors that impacts loan pricing (pricing is discussed further below).

A second suggestion has been made that the current regulatory framework disproportionately favours residential mortgage lending over small business lending activities due to lower capital attribution. For the purposes of capital allocation, Westpac notes the distinction between small business lending secured by residential property, lending secured by other assets[2] and unsecured lending. While these types of lending attract different regulatory capital requirements, Westpac supports risk-based capital allocation under the Basel Accord.

The approach to determining regulatory capital requirements for small business lending fully secured by a mortgage is the same as for a residential mortgage. However, capital requirements for mortgages vary with the risk associated with the borrower and historical loss experience. Small business lending secured by a mortgage has historically experienced higher losses than residential mortgages. As a result, capital requirements for small business lending are typically higher. Small business lending not secured by residential lending requires more capital than equivalent small business loans with better collateral. This also reflects higher actual losses.

For example, the table below demonstrates that Westpac losses on small business loans (secured by other assets and unsecured) have been 13 times higher than residential mortgage lending. Actual losses flow back into PD and LGD figures, thereby resulting in a higher risk weight. For example, the risk weight for small business is almost three times that of residential mortgage lending, thereby resulting in higher capital requirements.

Figure 5.3: Comparison of Westpac capital requirements and loss rates (Sep 2013)[3]

Asset Class	Risk Weight	8% Capital Requirement	12 month Loss Rate[4]
Residential mortgages*	14%	1.15%	0.03%
Small business	39%	3.12%	0.45%

* Includes business loans secured by residential property

1. Regulatory risk weights are generated by inputting estimates of the riskiness of the activity (such as the probability of default, loss given default, correlation and maturity) into a regulatory risk weight formula specified by the prudential regulations. Some of these risk inputs are determined by banks themselves subject to regulatory sign-off, based on internal modelling of the actual loss experience of the portfolios being modelled while other risk estimates are prescribed by the prudential rules.
2. This may include collateral such as: inventory, vehicles, equipment and accounts receivable.
3. Westpac Pillar 3 Report (September 2013). http://www.westpac.com.au/about-westpac/investor-centre/financial-information/basel-ii-risk-reports/
4. Reflects actual losses over the 12 months to September 2013 divided by the exposure (EAD) at the start of the period (September 2012).

CHAPTER 5
ENHANCING AUSTRALIA'S PRODUCTIVE CAPACITY: SUPPORTING SMEs

One area of regulatory reform that the Inquiry could consider to is the asset class thresholds under APS 113. APRA adopted a 1:1 basis for conversion of the €1 million threshold for the retail asset class (i.e. $1 million) rather than taking into account exchange rate differences. Increasing the threshold on exposures to, for example, $2 million could provide significant benefits to customers. For example, it would increase the speed of decision making by allowing a greater proportion of SMEs to be routed through our auto-decision making framework which is designed to handle volume and provide a fast and consistent credit decision. Furthermore, the annual review requirements of the corporate asset class (above $1 million) impose administrative burdens on businesses to provide certified financial statements to lenders. Increasing the threshold could reduce the impact of 'beige tape' on SMEs.

Pricing

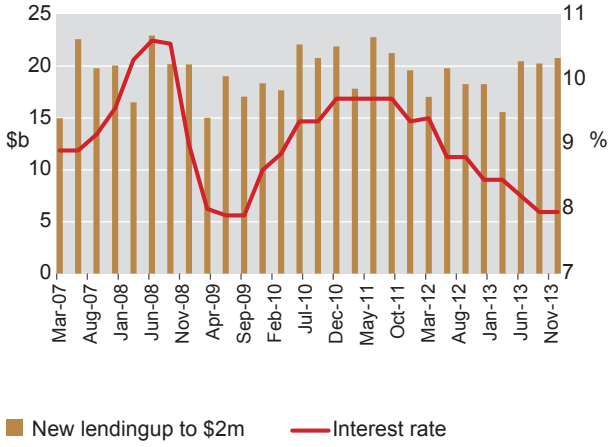
If a SME customer meets the bank's credit criteria and their loan application is approved, the pricing of their credit facility takes into consideration a range of factors including:

- Expected losses (and provisioning) i.e. PD and LGD;
- Capital required to be held against the loan;
- Costs of originating a new loan; and
- Cost of funding the loan.

In the current environment, funding costs and market competition remain the strongest drivers of pricing decisions.

SME customers have benefited from increased competition for business lending transactions through 2013. Lenders are offering comparatively cheaper lending rates due to the favourable movement in base rates, contractions in credit spreads due to increased competition and the general improvement in customer risk profiles as economic conditions improve. For SME customers the cost of borrowing has fallen as the cash rate has reduced. Interest rates for small business borrowers are at their lowest absolute level since 1993. The chart below illustrates recent interest rate movements on small business loans and loan volumes since the onset of the GFC. The chart demonstrates strong credit growth in periods of comparatively higher interest rates. This suggests that debt pricing is not a major barrier to the financing of small businesses and business confidence is a key driver of credit demand.

Figure 5.4 – Interest rate movements on small business loans[1] and business lending[2]



Source: RBA

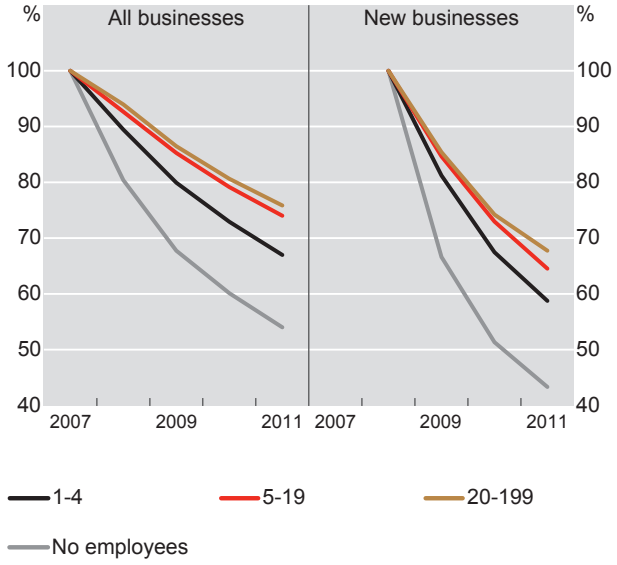
1. Small Business Term lending (excluding residentially secured) rates from the RBA F05 table – http://www.rba.gov.au/statistics/tables/xls/d07ahist.xls
2. Quarterly business lending up to $2 million – http://www.rba.gov.au/statistics/tables/xls/d07ehist.xls

Life cycle factors

In addition to the factors above, there are particular challenges for start-up SMEs which typically find it more challenging to meet lenders' requirements. They also represent a higher risk proposition for banks. ABS business survival rate data shows that less than 50% of small businesses are still operating four years after they commenced.

Historically, Westpac has found that the risk of loan default for a start-up has been double that of the remainder of the small business portfolio.

Figure 5.5: Small business survival rates[1]



Source: ABS

Mechanisms to improve lenders' access to information may not sufficiently close the gaps in trade and credit history for all start-up SMEs.

Traditionally, a lack of information may be overcome by provision of adequate collateral. Many start-up SMEs rely on non-conventional forms of collateral to demonstrate financial strength and creditworthiness. This is especially so for 'knowledge economy' businesses, such as technology, intellectual property and service-based SMEs.

Westpac will consider all types of collateral. Where no collateral is available, unsecured lending may be an option. However, as a responsible lender Westpac has strict requirements and a limited appetite around the types of unsecured lending made available.

Projected structural changes in the economy suggest that newer, innovative SME business models that rely on intangible assets will become increasingly important. It is likely, therefore, that growth in the unsecured lending market may be required. As noted above, any reduced security requirement would require measures to improve the level and quality of information available to lenders to assess borrowers' credit-worthiness and debt-serviceability.

Therefore, while the overall evidence suggests that debt finance is readily available for the Australian SME sector, there are some measures that could be implemented to further support SMEs' access to debt finance.

1. http://www.abs.gov.au/websitedbs/D3310114.nsf/4a256353001af3ed4b2562bb00121564/d291d673c4c5aab4ca257a330014dda2/$FILE/RBA%20Small%20Business%20An%20economic%20Overview%202012.pdf

5.6 ALTERNATIVE FINANCING OPTIONS

For a small subset of SMEs the provision of debt financing may fall outside appropriate risk management and responsible lending criteria. For example, where there is an absence of information (including business track record) and security. Alternative forms of financing for these businesses should be investigated, including:

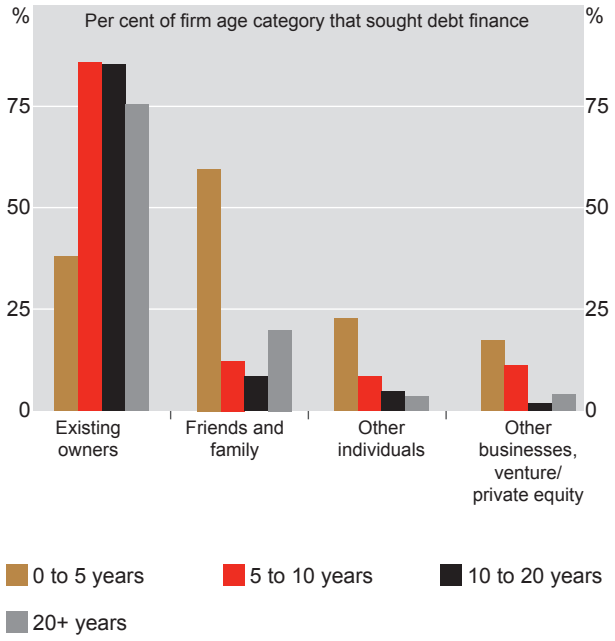
- Equity (including private equity and shared equity models) and venture capital; and
- Emerging financing trends (e.g. crowd funding and peer-to-peer lending).

The OECD has recognised the importance of alternative sources of financing for SMEs, particularly for innovative and start-up SMEs (with the potential for high growth) that are higher risk propositions due to their inability to satisfy lenders' requirements.[1]

5.6.1 External equity

In line with international trends, there is currently limited SME demand for equity finance in Australia. Small businesses tend to utilise internal equity finance or external equity sourced from friends and family.

Figure 5.6: Source of external equity finance[2]



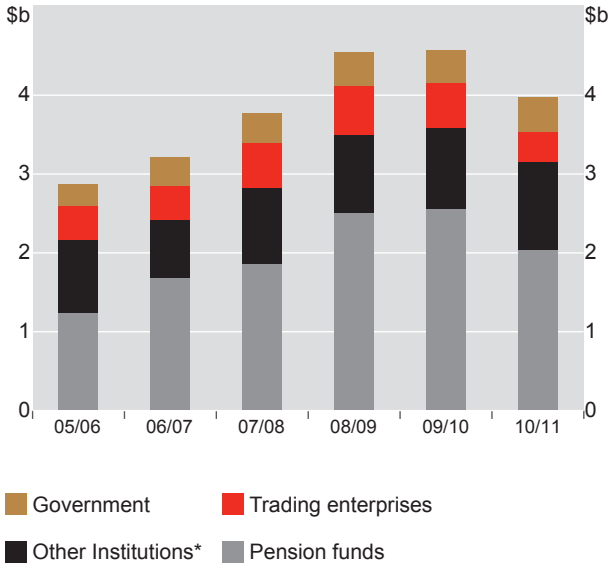
Source: ABS Business Longitudinal Database

There are a number of issues that may deter SMEs from seeking equity capital, including perceived loss of control, restricted management freedom, cost of securing equity finance and a lack of knowledge about financing options available. Internationally, only 1-2% of SMEs seek equity financing.[3]

It is difficult to assess exactly how much unmet demand there is for equity finance in Australia. For example, the data on venture capital suggests that this funding source has continued to increase over the last decade. However, the private equity and venture capital markets in Australia remain under-developed, in comparison to, for example, the US.

1. Organisation for Economic Co-Operation and Development, Small Business, Job Creation and Growth, Obstacles and Best Practices, 1997. http://www.oecd.org/industry/smes/2090740.pdf
2. http://www.rba.gov.au/publications/workshops/other/small-bus-fin-roundtable-2012/pdf/02-small-bus-funding-aus.pdf
3. UK Business Bank Advisory Group, Overview Paper.

Figure 5.7: Major sources of venture capital in Australia*[1]



*Includes ADIs, life insurers, trusts, other residents and non-residents

Source: ABS

Furthermore, the RBA has suggested that only a small fraction of businesses which seek venture capital funding are successful.[2]

Westpac recommends that a taskforce be established to bring together experts to consider ways to enhance alternative financing sources in Australia. Consideration could be given to the role of:

- Private equity;
- Start-up and growth funds – Two existing models include the British Business Bank and the UK Business Growth Fund. The expertise of banks could be leveraged by the Government to ensure a Government fund operates on a commercial basis and investments are focussed on SMEs with the greatest growth potential;
- Venture capital – An important vehicle for financing new and innovative high-risk, high return ventures. The EU provides an equity facility through the *Competitiveness of Enterprises and Small and Medium-sized Enterprises budget* (this includes venture capital and mezzanine finance to support expansion and growth-stage SMEs); and
- Tax – review of disincentives to alternative models, such as employee share ownership models that could assist with SME start-up and growth. Effectiveness of existing tax incentives to encourage managed investment schemes, superannuation funds, individual and corporate investors should also be examined. Currently, the UK provides various tax incentives to individual investors through the Enterprise Investment Scheme when they directly invest in unquoted companies, including income tax relief (30% of the investment), capital gains tax exemption, loss relief and capital gains tax deferral relief.

While Australian banks themselves may not be providers of equity finance or venture capital, the sector may have a role to play in facilitating connections between investors and SMEs. Furthermore, there may be a joint role for Government and industry to assist SMEs in effectively presenting themselves as investable opportunities and increasing awareness of the range of finance available and the type of finance that meets an SME's needs.

1. http://www.rba.gov.au/publications/workshops/other/small-bus-fin-roundtable-2012/pdf/02-small-bus-funding-aus.pdf
2. Matic. M. Gorajek. A, Stewart, C. Small business funding in Australia. 2012, p.16.

5.6.2 Emerging trends

The proposed taskforce could also give consideration to the emerging categories of crowdfunding (particularly as these forms of financing are collateral and covenant free).

The taskforce could examine the current availability and role of the following types of crowdfunding:

- Rewards – funds are contributed in exchange for future goods or services (existing platforms include Kickstarter and Indiegogo);
- Charity – donation based funding;
- Equity-based – generally restricted to accredited investors (both personal and institutional); and
- Lending (commonly known as peer-to-peer lending).

Importantly, greater capital from alternative sources such as equity could improve the creditworthiness of SME customers, improving the likelihood they will be able to obtain debt finance.

5.7 CONCLUSION

While there is little evidence to support suggestions that SMEs seeking debt financing from banks are experiencing significant difficulties, there are still improvements that could be made to further support SMEs (particularly start-ups). Private equity, venture capital and other alternative financing markets in Australia can be a source of finance for SMEs, particularly where debt financing is inappropriate. Given that these markets continue to be underdeveloped in Australia, the establishment of a separate taskforce to examine the alternate financing sources currently available, and opportunities for market development would be valuable. Increasing SME awareness of the range of finance available to suit their needs will remain vital to ensure efficient market functionality.

Westpac GROUP

Recommendations

Westpac recommends the establishment of a taskforce comprising Government and industry representatives to examine:

- Alternative financing in Australia (such as private equity, start-up and growth funds, venture capital and emerging trends), including current barriers to market development and potential opportunities to enhance the financing mix available to SMEs; and
- Opportunities for other forms of non-financial support to be increased, including providing SMEs education to increase awareness of the range of financing options available and improved expertise to apply for external (debt and equity) finance.

CHAPTER 6
BUILDING AND PROTECTING AUSTRALIA'S WEALTH

6.1 INTRODUCTION

The single largest change to the financial system since the Wallis Inquiry has been the rapid growth in the size of Australia's superannuation system. The continued growth of the industry will have strong implications for the entire financial system.

The current superannuation system operates on sound principles. But there is a need to reinforce the objective that the system aims to deliver up to 65-70% of income replacement in retirement for all Australians.

The system's settings should reinforce this objective. We urge the Inquiry to closely examine the regulatory, oversight, governance and market structure of the superannuation system to ensure that it is optimally placed to meet the needs of consumers, the financial system and the economy.

Australia's complex superannuation, taxation and social security systems mean that the majority of Australians will need some form of financial advice throughout their lives. As Australia's superannuation system continues to grow and more Australians reach retirement age, financial advice will play an even more critical role than it does today.

The insurance industry also plays a vital role in supporting the Australian economy. An appropriate shared Government and industry vision is required to inform the policy settings affecting the industry, to ensure it is able to efficiently and effectively manage risk.

The growth in superannuation means Australia now has the third largest pool of managed funds in the world. There are largely undeveloped opportunities to export our funds management services to Asia. A renewed commitment to the recommendations of the Johnson Report is necessary to realise this opportunity.

6.2 SUPERANNUATION

6.2.1 The superannuation system

When the Wallis Inquiry presented its findings, the superannuation system was still in its infancy. The Superannuation Guarantee (SG), introduced in 1992, had reached 6% and total superannuation assets were $279.5 billion.[1]

Since that time, we have seen year on year average compound growth of 12%, taking superannuation assets to $1.8 trillion.[2] This rapid growth rate has been underpinned by strong mandatory employer and discretionary personal contributions.

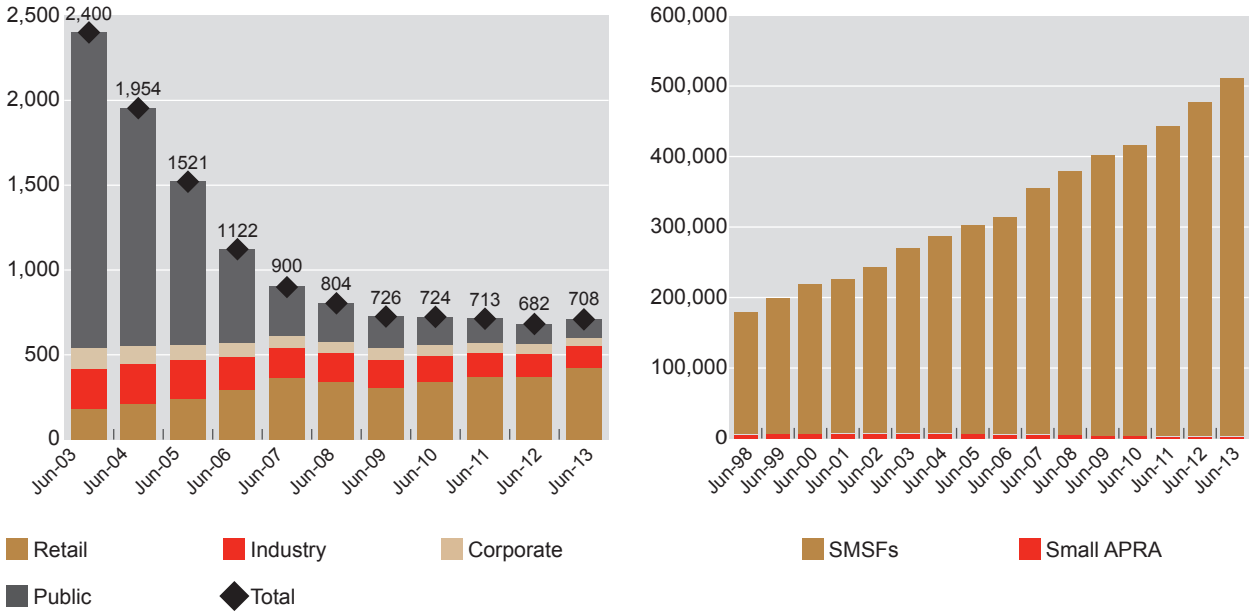
At the same time, there has been a significant shift in the types and number of entities involved in managing the superannuation pool of assets. Over the last decade, institutional superannuation entities have been consistently consolidating or winding up. At June 2004, the number of institutional superannuation entities was 1,908 and by June 2013 the number had fallen to 386 funds.[3] The number of SMSFs has continued to grow rapidly. At June 2004, the number of SMSFs was 279,584, but by June 2013 the number had reached 512,375 entities (covering 968,000 individuals).[4]

Chapter 6

1. APRA, Superannuation and Insurance Bulletin, Page 24, March 1997. http://www.apra.gov.au/Super/Publications/Documents/Insurance-and-Superannuation-Bulletin-Articles-for-March-1997-in-PDF-format-141kb.pdf
2. APRA Statistics – Quarterly Superannuation Performance, December 2013 (interim edition).
3. Table 1, APRA Statistics – Annual Superannuation Bulletin, June 2013 (revised 5 February 2014).
4. Table 1, APRA Statistics – Annual Superannuation Bulletin, June 2013 (revised 5 February 2014).

CHAPTER 6
BUILDING AND PROTECTING AUSTRALIA'S WEALTH

Figure 6.1 – Consolidation of institutional superannuation entities and increase in SMSFs



These trends are broadly expected to continue. Deloitte Actuaries & Consultants recently projected total superannuation assets will reach $7.6 trillion by 2033. It is therefore critical to understand the system's level of maturity – broadly, the extent to which it is meeting its central objective of providing adequate retirement incomes.

Notwithstanding the pool of superannuation assets already exceeds Australia's GDP, the system is still far from mature. The average member balance in 2013 has been estimated at $95,000.[1] Most Australians have only been receiving an employer contribution at the 9% SG rate for just over a decade. It will be almost another seven years before Australians begin receiving mandatory employer contributions at the full 12% SG rate (starting from July 2021). As a result, the system will only produce its first full '12%' retiree in 2063.[2]

6.2.2 Superannuation asset allocation

Implications of a defined contribution system

Australia's superannuation system is a Defined Contribution (DC) system. DC systems typically have two key characteristics:

- The amount saved is entirely a function of employee and employer contributions and investment earnings over the duration of the plan; and
- Savings are not guaranteed and fluctuate based on investment earnings over the duration of the plan.

This is in contrast to a Defined Benefit (DB) system whereby an employer promises a specified benefit (level of income) on retirement that is based on a formula which takes into account the employee's earnings, tenure and age.

Under a DC system, the member therefore bears the risk of not generating sufficient savings to fund their retirement. Under a DB system, this risk is borne by the employer – who is required to fund the plan and monitor on an ongoing basis how plan assets are tracking against projected future liabilities.

1. Rice Warner Actuaries. Superannuation Market Projections, 2013.
2. Starting at age 18 in 2021 and retiring at age 60 as per the current preservation age.

The nature of these two pension systems creates very different incentive structures for the managers/trustees of the underlying assets and therefore helps to explain the asset allocation of Australia's superannuation system.

Under a DB system, trustees have a lower tolerance for volatility and are more income oriented. This typically produces a more conservative asset allocation as noted in a recent report by Mercer, commissioned by the Financial Services Council.[1]

In the report, Mercer states that most of the assets suitable for matching these liabilities are bonds and other fixed income investments.

In contrast, under a DC system like Australia's, managers/trustees have an incentive to maximise the investment returns within the fund without managing against a specific target or objective.

As a result, the incentives are primarily geared towards balance accumulation rather than income generation. It is therefore not surprising that there is a high allocation to growth assets under Australia's system relative to other pension systems and a correspondingly lower demand for bonds and other fixed income investments.

This focus on balance accumulation without a clear income replacement target means that individuals are potentially invested in higher risk portfolios at an inappropriate time – that is, the lead up to retirement. This means they are exposed to the risk of investment losses at a time when their balance is at its highest and when they do not have sufficient time to make up the loss through future contributions and investment returns.

Options encouraging superannuants to take out an income stream in retirement (as outlined in Chapter 4) would likely drive a more conservative asset allocation within the system, as well as impact the manner in which trustees manage member monies in seeking to achieve a targeted level of lifetime income. In effect, trustees would behave more consistently with trustees of DB schemes.

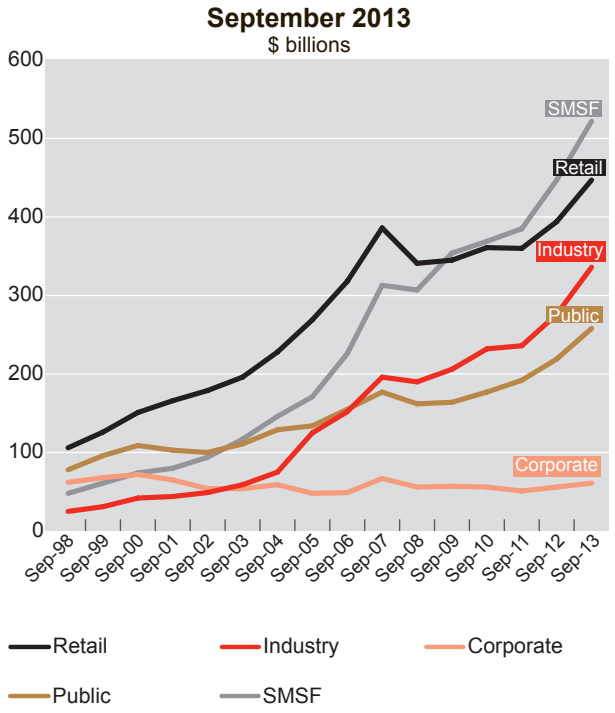
1. Mercer. 'Asset allocations of pension funds around the world', 2014.

CHAPTER 6
BUILDING AND PROTECTING AUSTRALIA'S WEALTH

Current trends in asset allocation

Asset allocations vary across the sector, in particular between SMSFs and institutional investors. Over the past ten years there has been acceleration in the amount of assets held within SMSFs.

Figure 6.2 – Relative growth of total assets within SMSFs



Asset allocations between institutional (including corporate, industry, public sector and retail funds) and SMSFs are, on average, very different. SMSFs have tended to hold a much larger proportion of their assets in cash and unlisted property. The average superannuation asset allocations as at 30 June 2013 were:

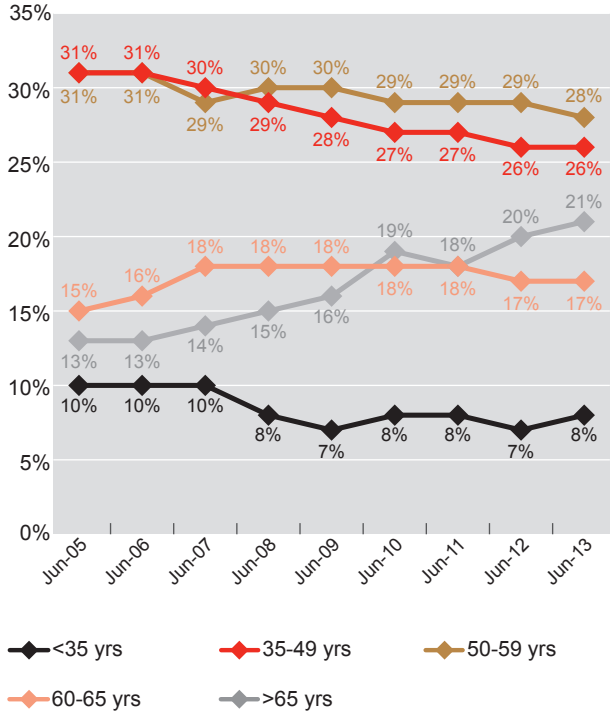
Asset Classes	Institutional Funds[1]	SMSFs[2]
Australian Shares	26%	32%
International Shares	25%	<1%
Unlisted Property	7%	15%
Australian Fixed Interest	9%	1%
Cash	8%	30%

The trend of Australia's ageing population has been well documented and reported on as a result of the Intergenerational Reports (IGR). The 2010 IGR estimated that by 2050 the number of older Australians (60 to 84 years) is expected to double.[3]

1. Table 18, APRA Statistics – Annual Superannuation Bulletin, June 2013 (revised 5 February 2014).
2. ATO Self-managed super fund statistical report, June 2013. http://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-super-fund-statistical-report---June-2013/
3. Treasury, Intergenerational Report 2010, Overview. http://archive.treasury.gov.au/igr/igr2010/Overview/html/overview_04.htm

Over the past eight years the share of total superannuation assets held by members aged 60 and over grew from 28% to 38%. This ageing of the population will result in a greater percentage of assets being invested in the pension phase of superannuation.

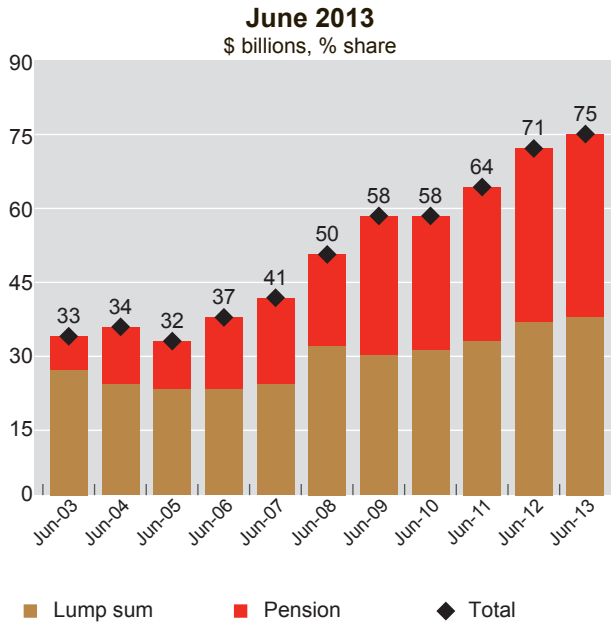
Figure 6.3 – Vested superannuation benefit by age segment



This trend is manifested in data relating to the prevalence of lump sums versus income streams. Over the last 10 years, the compound annual growth rate of lump sums has been 3%, while regular income from pensions has grown at 18%, comprising approximately 50% of all withdrawals from the system in 2013.

This outcome reflects the continuing maturity of the superannuation system. As increasing numbers of individuals retire with larger balances, they are more likely to convert their balance into an income stream.

Figure 6.4 – Annual superannuation pension and lump sum payments



As a consequence, as the superannuation system continues to grow and members on average continue to age, it will alter asset allocations for three key reasons:

- The superannuation system will outgrow local equity markets. The superannuation pool, at around $1.8 trillion already exceeds the total market capitalisation of companies listed on the ASX ($1.347 trillion as at June 2013). As superannuation grows to $7 trillion, it will inevitably need to invest outside of the domestic equities market;
- As the assets in SMSFs continue to increase and as the average age of individuals invested in superannuation continue to rise, the percentage of superannuation assets invested in defensive assets will also likely increase; and
- As the shift from accumulation to pension takes place, a greater proportion of individuals will be drawing down on their superannuation rather than continuing to contribute. BTFG analysis shows that in 2040, outflows from superannuation – for the first time – are expected to be matched by inflows, signalling a tipping point in the system.

6.2.3 Assessing the long term performance of superannuation

There has been considerable speculation about the appropriateness of the present asset allocation within the superannuation system. Much of the speculation was prompted by the adverse impact of the GFC on member balances.

The annualised nominal return over the 21 year period since the introduction of compulsory superannuation is 8%, while the annual CPI increase was 2.6%. The system has therefore delivered an average real return above inflation of 5.4% per annum. In terms of the risk levels that savers have been exposed to, there were four negative years out of the past 21.

During the depths of the GFC, the median growth fund sustained a 21.5% loss. However, these funds are now approximately 21% above their pre-GFC high achieved in October 2007.

Given the relative immaturity of the system evidenced by the strong accumulation bias (with approximately two-thirds of assets in the accumulation phase), these aggregate performance outcomes demonstrate the strength of the system's performance for the accumulation phase.

6.3 ADEQUACY

Australia, along with much of the developed world, will soon be facing the demographic challenges associated with an ageing population. This demographic shift will be compounded as life expectancy continues to grow. In 2033, men who reach 65 will live on average to 91 and women to 93.[1]

As a result, people born after 1968 will have to consider how to support themselves for up to 30 years after retirement.[2]

A critical benefit of the superannuation system is its ability to support economic growth as Australia's population ages. Without substantial numbers of self-funded retirees, future governments will face the challenge of needing to increase taxes or reduce or limit access to the age pension.

6.3.1 Defining an adequate level of income in retirement

A Senate Committee in 2002 found that retirees needed to replace 65% of their pre-retirement income to live comfortably.[3] This supports the original intention that superannuation should aim to replace 70% of an individual's pre-retirement income when in retirement.

Analysis prepared for Westpac shows that based on the full 12% SG rate and a real rate of return of 5%, a male aged 20 entering the workforce would only achieve the following income replacement rates at retirement:

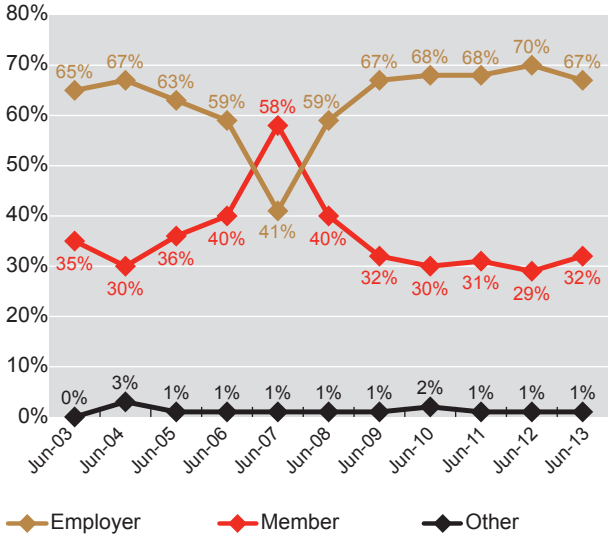
Assumed Income	Income Replacement Rate
$40,000	70% (Due to the Government age pension)
$40,000	31% (Without the Government age pension)
$72,000 (average income)	51%
$120,000	37%

These outcomes demonstrate the importance of voluntary contributions in the system if a replacement rate up to 65-70% is to be achieved. Voluntary contributions are even more important for women who are more likely to experience time out of the workforce.

Over the last decade, employer contributions have constituted around two-thirds of total annual contributions, with personal contributions consistently around one-third of total contributions.

1. Rice Warner Actuaries, BTFG report.
2. Actuaries Institute, 'Australia's Longevity Tsunami', August 2012. page 6.
3. Select Committee on Superannuation, Superannuation and standards of living in retirement, Report on the adequacy of the tax arrangements for superannuation and related policy December 2002.

Figure 6.5 – Percentage of annual personal v employer superannuation contributions



The distribution of voluntary contributions is likely to be highly skewed by higher income earners and older Australians who have a greater capacity to contribute voluntarily. If the system is to deliver adequate incomes, it is therefore critical to ensure that as many Australians as possible make voluntary contributions.

Defining a target income replacement rate for the superannuation system is critical to driving an appropriate asset allocation across the system; highlighting to members the importance of voluntary contributions; and ultimately to being able to assess the success of the system.

Once a target income replacement rate has been determined, all relevant system settings should seek to reinforce this objective.

In particular, the Inquiry should satisfy itself that existing superannuation tax and regulatory settings allow and encourage Australians to achieve the desired income replacement rate (i.e. up to 65-70%) in retirement.

This will necessarily involve an assessment of the effectiveness of the key features of the system – the SG, Concessional Contribution Caps, Co-Contribution regime and consideration of other measures affecting member contributions.

Importantly, these settings must also be designed in a manner that recognises fiscal constraints. It is not appropriate for tax concessions on superannuation to be provided in circumstances which extend beyond these objectives.

Finally, the Inquiry should consider the role of disclosure settings in reinforcing the objective of saving for a target level of income in retirement.

Westpac urges the Inquiry to reinforce key principles that underpin the current superannuation system. Most importantly, the system should aim to deliver a level of income replacement in retirement of up to 65% to 70% for all Australians — and that the system's settings, including disclosure and other requirements, should all reinforce this objective.

6.4 OVERSIGHT & GOVERNANCE

6.4.1 Regulatory framework

As a sector, SMSFs did not exist at the time the Wallis inquiry was conducted, having only been established as a separate legal structure in 1999. Today there are over 500,000 funds, with more than one million members holding in excess of $500 billion.

The current regulation of the SMSF sector does not reflect its importance to the Australian economy. There remains no macro-prudential oversight or analysis of its systemic implications. As a result, there continues to be a poor understanding of the implications of the sector on the financial system and economy. It is now time to consider appropriately targeted macro oversight of the sector.

The superannuation regulatory framework was examined during the former Federal Government's 'Super System Review' (also known as the Cooper Review). But it remains appropriate for the Inquiry to revisit these issues in the context of the broader economy and financial system. Further, the implementation of many of the recommendations from the Cooper Review has significantly increased the cost and burden of regulation on the superannuation sector, particularly as a result of the introduction of MySuper, SuperStream and APRA Prudential Standards.

Westpac believes there is a need to review and enhance the regulatory framework applying to superannuation to:

- Provide greater consistency across sectors and between organisational structures;
- Introduce an appropriate model for macro oversight of the SMSF sector; and
- Remove unnecessary duplication and improve efficiency.

6.4.2 Regulatory framework assessment: APRA regulated funds

Governance

Westpac supports the introduction of consistent governance standards across banking, insurance and superannuation. Specifically, this should be achieved through the introduction of uniform requirements for superannuation boards to have an independent chair and a majority of independent directors.

Consistency across APRA-regulated financial services providers simplifies the regulatory framework and eliminates unnecessary variation in governance models across the financial services industry. Westpac notes that with the only exception of superannuation, APRA currently mandates that regulated entities such as insurers and ADIs have both an independent chair and that the majority of directors are also independent.

In addition, the ASX believes a predominantly independent board of directors is best practice for listed entities.

The case for stronger governance arrangements in superannuation is only reinforced by the future growth of the industry. The Cooper Review forecast that by 2035, there would be 74 large funds, with the largest managing approximately $350 billion.[1]

Australians must have confidence that superannuation funds are governed to the highest standards as a key driver of the effectiveness of the superannuation system.

Payments

Westpac supports the alignment of SuperStream with the payment system to facilitate the payment and allocation of superannuation member monies on a more robust, efficient and cost effective basis.

1. http://www.supersystemreview.gov.au/content/downloads/final_report/part_one/Final_Report_Part_1_Consolidated.pdf

CHAPTER 6
BUILDING AND PROTECTING AUSTRALIA'S WEALTH

Westpac has been a strong supporter of innovation in the superannuation payment system for many years. Within the Westpac Group, BTFG has been a key participant in industry innovation for over a decade prior to SuperStream in industry e-commerce projects such as SwimEC. Westpac Institutional Bank is the market leading provider of superannuation clearing house services through the QuickSuper product.

SuperStream is currently introducing mandatory data and payment standards into the superannuation system. The introduction of the reform package was phased between rollovers (currently being implemented) and contributions as phase two (currently legislated to commence 1 July 2014). Phase two will apply mandatory data standards to the superannuation contributions made initially by large and medium sized employers and subsequently small employers.

Westpac believes SuperStream will deliver operational efficiencies for the superannuation industry over the medium term. But it still leaves industry with destination reconciliation of monies and data, along with the ongoing costs of maintaining the SuperStream infrastructure. These costs are unique to superannuation and are inefficient in the light of developments in other areas.

The RBA strategic review of innovation in the payments system identified the current inability of the direct entry system to support the remittance of data as inadequate for some business purposes.[1]

In response, the industry has commenced the New Payments Platform project (NPP), due for roll out by the end of 2016. Once this NPP nears completion, both industry and Government will need to work together to ensure SuperStream requirements are aligned with the mainstream payments system.

Superannuation should not be required to maintain a separate system that will become redundant following the upgrading of the payment system. Utilising the mainstream payments system provides a more robust, efficient and cost effective basis to process in excess of 100 million annual superannuation contributions.

Competition

The superannuation industry is highly competitive, with both a large number of providers and the ability of members to exercise choice of fund – including the ultimate choice to self-manage their savings outside of the APRA regulated sector. Irrespective of the overall competitive landscape, there remains a segment of the market in which competition is artificially constrained – namely the selection of default funds within Modern Awards.

The current and historical process of nominating default funds in Modern Awards lacks transparency and competitive tension. Allowing employers to select any MySuper default fund will enhance competition in the superannuation market.

According to the Productivity Commission, around $6 billion, and potentially more than $9 billion, in superannuation contributions were made to default funds in Awards in 2010.[2] The introduction of MySuper renders a separate process through the Fair Work Commission (FWC) for the selection of default funds in Modern Awards redundant.

The existence of MySuper, enhanced public reporting by APRA and a highly competitive market for default superannuation will ensure that employers are able to select an appropriate default fund provider.

In Westpac's view, the current FWC process should be replaced with an open market for default superannuation by allowing an employer to select from any APRA MySuper product.

1. RBA. Strategic Review of Innovation in the Payment System, Conclusions, May 2012, pp 9-10.
2. Productivity Commission. Default Superannuation Funds in Modern Awards http://www.pc.gov.au/__data/assets/pdf_file/0011/119981/default-super.pdf

6.4.3 Regulatory framework assessment: Non-APRA regulated funds (SMSFs)

Westpac actively supports a vibrant and competitive superannuation industry that includes SMSFs. However, given the size and increasing importance of the sector and the extent of public commentary on the sector, Westpac believes it is important for the stability of the superannuation and financial system that an appropriate model for marco oversight of SMSFs be considered.

The SMSF sector is both the largest and fastest growing within the superannuation industry. There are over 500,000 funds, with over 1 million members holding in excess of $500 billion in assets. The SMSF sector is now systemically relevant – within the financial system and in terms of the Government revenue implications of any widespread failure.

From a policy perspective, the key questions in relation to the sector include:

- Are the right individuals establishing a SMSF;
- Is the financial or other advice provided to these individuals in their best interest;
- Do trustees and members of SMSFs understand the added responsibilities and differences in consumer protection relative to APRA regulated funds;
- Are relevant investment and preservation rules being complied with; and
- What are the economic and financial system implications of the continued growth of the SMSF sector.

The current regulatory regime addresses only some of these elements satisfactorily. Oversight of SMSFs is primarily achieved through annual auditing requirements, and ATO compliance data suggests that the SMSF sector is, overall, highly compliant – with only around 2% of funds lodging contravention reports each year.[1]

Additionally, recent FoFA and related reforms, including the removal of the so-called 'accountants exemption' and the introduction of the best interests duty, have strengthened the regulation of SMSF gatekeepers.

But there remains no oversight or analysis of the systemic implications of the sector. This poses important issues for the Government and SMSF members including:

- Risk of shortfalls in retirement savings due to poor management and/or mismanagement;
- Calls to compensate SMSF members in the event of a failure; and
- Poor understanding of the economic and financial system implications of the sector.

At present, the quality and depth of data in relation to SMSFs is also inadequate given the size of the sector. Official data is reported with a significant lag (e.g. June 2013 statistics published by the ATO are extrapolated from 2011–12 data) and there is little analysis of trends and underlying investments.

To address this supervisory gap, Westpac supports a financial regulator being given oversight of the sector as a whole. This would not involve the financial regulator directly regulating individual SMSFs. Rather, they would more closely examine investment portfolios within the SMSF sector in order to better advise government on the ongoing systemic implications of the sector.

Granting a financial regulator macro oversight would allow for more informed commentary and policy development.

1. http://www.ato.gov.au/Media-centre/Speeches/Other/Issues-affecting-SMSFs--the-ATO-perspective/

6.4.4 Consideration of a legislative SMSF compensation mechanism

Members of APRA-regulated superannuation funds benefit from access to a legislative compensation mechanism in the event of a loss as result of fraudulent conduct or theft.

This protection is not afforded to members of SMSFs. This reflects the principle that SMSFs are a distinct type of superannuation fund whereby the individual accepts personal responsibility for its management and oversight. The ongoing appropriateness of this principle, in this context, needs to be reconsidered.

Notwithstanding the strengthening of the regulatory framework applying to SMSFs, hundreds of thousands of individuals established an SMSF prior to these reforms. Additionally, there are a range of other factors that warrant further consideration of an SMSF compensation mechanism, including:

- Older membership base, with a significant proportion of assets in pension phase;
- Ease with which SMSFs can be established directly; and
- Questions about the degree to which SMSF members are aware of the risks to which they are exposed.

Importantly, such a protection would not extend beyond fraud or theft, as is the case with the existing APRA-regulated fund mechanism.

A compensation mechanism would protect taxpayers from potential future calls by SMSF members to be compensated by government for losses incurred due to fraud or theft. It would also reduce the burden on government (and future taxpayers) from affected individuals having to rely on the age pension rather than their superannuation savings.

The introduction of an SMSF compensation mechanism would also alleviate public pressures for a wider compensation mechanism applying to all financial products and services, in doing so avoiding the introduction of greater moral hazard into the financial system.

6.5 FINANCIAL ADVICE

As Australia's superannuation system continues to grow and more Australians reach retirement age, financial advice will play an even more critical role than it already does today.

The value of quality financial advice extends well beyond assisting those individuals who receive it.

Research conducted by KPMG provides an analysis of how financial advice affects savings behaviour. It shows that comparable individuals with a financial adviser save an additional $1,590 a year after advice costs compared to those without a financial adviser.[1] In the case of a 30-year-old, it would mean they save an additional $91,000 more than those without a financial adviser.

The research also found that if an extra 5% of Australians received financial advice, national savings would increase by $4.2 billion (0.3% of GDP) by 2016-17.

In addition to savings behaviour, the research also considered the level of life insurance held by those with and without financial advisers. It found that, on average, those with a financial adviser were at least four times more likely to hold some form of life insurance.

This is supported by industry studies, also compiled by KPMG, which show those who received financial advice had on average $260,000 worth of life insurance cover compared with only $100,000 for those who purchased insurance directly.[2]

1. KPMG. Value proposition of financial advisory networks, 2011.
2. Lifewise/NATSEM Underinsurance Report 2010.

6.5.1 Regulatory architecture

Financial advice has undergone significant reform over the last three years. In addition to the FoFA reforms, the industry has also been heavily impacted by a separate Tax Agent Services regime.

Westpac believes that the ongoing application of two separate regimes will give rise to operational complexity and uncertainty – already evident in recent calls for clarification in the interaction between FoFA and the Tax Agent Services regime.

This complexity and duplication is also evident in relation to the training and competency requirements imposed on financial planners. Both ASIC and the Tax Practitioners Board now have a role in this area.

In its place, Westpac supports a rationalisation and centralisation of the training and competency requirements applying to financial advice. This could be best achieved by establishing a new body with delegated authority under the *Corporations Act 2001.*

6.5.2 Professional standards

While financial advice continues to be the subject of significant reform, there remains a need to further enhance trust in the sector. Westpac believes that this is best achieved through improving the training and capabilities of financial advisers who provide personal advice.

Importantly, the raising of professional standards needs to be done sustainably – without adversely impacting the affordability of advice. To balance these objectives, Westpac believes the following approach is needed:

- A holistic approach to professional development should be adopted for the advice industry to achieve sustained improvements in the quality of advice and raise consumer trust and confidence in the industry; and
- Standards should ensure quality without reducing affordability and accessibility. Affordable and accessible advice requires the alignment of education standards with the complexity of advice.

As outlined above, a new body should be established to develop a personal advice standards framework. All Australian Financial Services Licensees (AFSLs) that are authorised to provide personal financial product advice should both fund this new body and be required to adhere to the professional development standards it establishes.

6.6 INSURANCE

A critical measure of a well-functioning financial system is its ability to allow individuals, households, businesses and governments to efficiently and effectively manage risk.

Within the financial system, the insurance industry plays a central role in risk management across the economy. Consequently, improving the efficiency and effectiveness of the insurance industry has a direct impact on economic efficiency and growth.

Additionally, given Australia's extensive social security arrangements, all governments have a direct interest in the industry's ability to perform its role.

CHAPTER 6
BUILDING AND PROTECTING AUSTRALIA'S WEALTH

6.7 GENERAL INSURANCE

6.7.1 Addressing the underinsurance gap by removing disincentives to insure and improving affordability

Underinsurance is a major risk to Australian households and businesses. It exposes customers to significant loss if the sum insured is inadequate and cannot cover the cost of rebuilding or repair after total loss or damage is incurred.

The extent of underinsurance is widespread across Australia and several reports over many years have confirmed this. For instance, a survey by ASIC of 1,000 randomly selected households by a company specialising in estimating rebuilding costs found that:[1]

- 87% of homes were insured for less than their replacement value and that the average level of underinsurance was 34%;
- 81% of homes were underinsured by 10% or more; and
- 59% of homes were underinsured by 30% or more.

Given the extent and level of underinsurance, it is important for the Inquiry to consider the key drivers of underinsurance and how they can be addressed. Westpac believes that affordability; complexity; increasing building costs and general inflation are the main drivers of underinsurance – each is addressed below:

- Affordability of insurance – insurance taxes and rising premiums reduce the affordability of insurance for consumers;
- Complexity in calculating the correct sum insured – consumers are responsible for determining the replacement value of their property in Australia. This is a complex process requiring technical knowledge and access to data on rebuilding costs;
- Accumulation and upgrading value of possessions – consumers grow the number and value of their possessions over time and can often fail to review their level of cover and make appropriate changes; and
- Increasing building costs and general inflation – the cost of building increases each year while changing building regulations and planning laws also impact. Construction costs also often increase after a major disaster because the demand for labour and building materials is higher.

While individual insurers will continue to work on addressing the problem of underinsurance directly with their customers, all levels of government could consider ways they can:

- Improve affordability through the abolition of insurance taxes;
- Improve affordability through natural peril mitigation strategies that will ultimately reduce risks and lower premiums in high risk areas;
- Improve consumer understanding of the impacts of underinsurance and non-insurance through co-ordinated public education campaigns that explain the impacts and encourage a regular review of insurance needs; and
- In relation to local government specifically, all changes to building codes and planning laws should be communicated to ratepayers with advice on how to reassess their insurance requirements in light of these changes.

1. 'Getting Home Insurance Right – A report on home building insurance' September 2005.

Taxation of general insurance

Insurance taxes impact the overall affordability of insurance and can distort the purchasing behaviour of consumers such that they either choose not to purchase insurance, reduce their level of cover, or increase their excess to reduce their total insurance premium.

Any negative impact on the level of non-insurance ultimately leads to calls for government to step in and ultimately fund disaster recovery for those people with no insurance. This in turn reduces the perceived benefits of insurance and drives levels of non-insurance even further, creating a vicious circle.

The Henry Review in 2010 recognised this and recommended the removal of state based duties as soon as possible, with only the GST being applicable to insurance premiums.

Westpac suggests that the Inquiry reinforce the recommendations of the Henry Review that state governments should abolish all taxes on insurance in line with previous reviews of the system to minimise the effects of non-insurance and underinsurance. This matter should be further considered under the tax white paper process expected to commence later this year.

6.7.2 Enhancing Australia's resilience to natural disaster

There is considerable scope to improve the affordability of insurance through natural peril mitigation strategies that will ultimately reduce risks and lower premiums in high risk areas.

Australia has a long history of natural disasters and experiences a range of perils including bushfires, floods, cyclones, hail storms and earthquakes. According to the Australian Business Roundtable for Disaster Resilience and Safer Communities, each year an estimated $560 million is spent on post-disaster relief and recovery by the Australian Government compared with an estimated consistent annual expenditure of $50 million on pre-disaster resilience: a ratio of more than $10 post-disaster for every $1 spent pre-disaster.[1]

The total economic cost of natural disasters alone exceeded $6 billion in 2012, with this figure expected to double by 2030 and increase to an average of $23 billion per year by 2050. It is clear from this report that natural disaster costs are forecast to increase significantly in the future and that there is currently an inadequate amount of government spending on preventative initiatives that would improve community resilience to natural perils.

According to the Roundtable's report an annual program of Australian Government expenditure on pre-disaster resilience of $250 million at the national level has the potential to generate budget savings of $12.2 billion for all levels of government (including $9.8 billion for the Australian Government) and would reduce natural disaster costs by more than 50% by 2050.

Importantly, natural disaster mitigation does not only require investment in infrastructure projects that focus on pre-disaster resilience but also:

- Improved local planning building standards that address resilience to natural disaster;
- Education programs aimed at improving awareness of natural disaster and steps to mitigate the risks; and
- Improved collation and sharing of natural peril data and mapping that can be used across all levels of government for better planning and risk management.

Natural disaster mitigation will not only improve the overall safety and resilience of the community but also make insurance more affordable by reducing risk to specific perils and exerting downward pressure on premiums.

1. Australian Business Roundtable for Disaster Resilience and Safer Communities. Building our nation's resilience to natural disasters, June 2013.

CHAPTER 6
BUILDING AND PROTECTING AUSTRALIA'S WEALTH

In line with the recommendations of the Business Roundtable the Inquiry should urge all levels of government to increase funding of mitigation activities to reduce the high risk of incurring significant economic and social costs and improve community resilience to the effects of natural peril.

Natural disaster mitigation would also be boosted by consumers having better access to flood risk assessments. In a positive development in 2012, the Federal Government committed $12 million over four years to the development of the National Flood Risk Information Program (NFRIP) that would improve the quality, availability and accessibility of flood information across Australia.

However, this process could be further improved. Westpac believes that the Federal Government could enhance the NFRIP by ensuring it provides:

- Consistent flood mapping with the use of the National Flood Information Database (NFID) at a minimum given its predominant use by insurers and broad coverage across Australia;
- Specific address based flood risk assessment so consumers can identify the extent of flood risk at their individual property address; and
- Additional information such as the Average Recurrence Interval (ARI) and Flood Depth so consumers can better understand the flood risk they face and take appropriate mitigation activities.

6.8 LIFE INSURANCE

6.8.1 Introduction

The financial burden of injury and illness is most efficiently borne where those who are able to, insure against these risks. This reduces the burden on Government funded support such as social security, the National Disability Insurance Scheme and a range of other Government support services.

Rice Warner's Underinsurance in Australia Report 2013 highlighted the total cost to the government of underinsurance for life, Total and Permanent Disability (TPD) and income protection as around $1.6 billion per annum.

The Disability Support Pension (DSP) is estimated to account for $15.5 billion of Government expenses in 2013-14.[1] Recent KPMG modelling shows that the Government could save $2.5 billion per annum in DSP payments after 10 years through adequate disability insurance levels.[2]

To ensure the industry is able to efficiently and effectively manage risk across the economy and minimise the burden on government, the Inquiry should consider measures to address:

- Underinsurance in Australia;
- Stability and efficiency of insurance in Australia; and
- The industry's ability to innovate in consumers' best interests.

1. Australian Government, 2013-2014 Budget Paper No. 1, Statement 6: Expenses and Net Capital Investment.
2. KPMG, Underinsurance – Disability Insurance Protection Gap in Australia, 2014.

6.8.2 Underinsurance in Australia

Australia is significantly underinsured when compared to other countries with only 3% penetration. The United Kingdom for example has 9% penetration.[1]

Roughly 9.5 million Australians, or 44% of the population, are employed and could mitigate the economic risks of disability through private disability insurance.[2] Of these, 35% do not have any private disability insurance at all and, on aggregate, the level of disability underinsurance is estimated to be $304 billion per annum.

Clearly the financial system is not delivering to its potential if such a low proportion of the population is adequately covered.

Incentivising the take-up of life insurance for low to middle income Australians

Many Australians are currently discouraged from taking out insurance by virtue of losing access to social welfare benefits. At present, there is an overlap between Government subsidised support and privately held life insurance which discourages low to middle income Australians to self-fund their own protection needs. To address this, the Government could consider the introduction of measures to encourage more Australians to self-fund their insurance needs.

Benchmarking standards

Another potential driver of underinsurance in Australia is the lack of trust by consumers in the life insurance industry, primarily based on misconceptions around the expected experience when lodging a claim. The introduction of an independent review mechanism to benchmark claims practice across the life insurance industry would promote consumer protection and industry sustainability.

Product Standards

Implementing clear and concise standard definitions, would improve the understanding and confidence of consumers in life insurance. Greater transparency through clarity of disclosure for the consumer would assist to improve take up of life insurance by making it possible to objectively compare the payout levels of the various life companies. 'Plain English' wording of standardised definitions would provide consumers certainty at claim time, as has been achieved through international examples across the UK, Singapore and South Africa.

Standard definitions should not represent a mandated minimum or maximum level of cover, but rather act as a benchmark for consumers to compare product offerings.

Contribution caps

At their present low levels, superannuation contribution caps are being eroded by the value of insurance premiums paid within superannuation. Consideration needs to be given to alternative arrangements that would alleviate the impact of insurance premiums on retirement incomes. One option for addressing the impact of insurance on retirement incomes is for a member's total concessional contributions for a year, or the total amount of concessional contributions reported on the Member Contributions statement, to be reduced by any insurance premiums paid from the member's superannuation fund(s).

This model would allow individuals to make additional voluntary contributions to the value of their insurance premiums, without being disadvantaged for taking out appropriate levels of cover.

1. Swiss Re Sigma World Insurance Report, 2010, McKinsey GFIC, EMEA Banking Group.
2. KPMG, Underinsurance – Disability Insurance Protection Gap in Australia, 2014.

6.8.3 Stability and efficiency of insurance in Australia

The sector's ability to efficiently and effectively manage risk is constrained by complex, duplicative and inefficient regulation.

Onerous regulatory regimes

The regulation of life insurance products is currently highly complex and technical, creating inefficiencies in the market and burdening the industry with unnecessary costs resulting in higher than necessary premiums for consumers.

Legislation impacting the industry is spread across the *Corporations Act 2001*, *ASIC Act*, *Insurance Contracts Act 1984* and *Life Insurance Act 1995*. Other relevant legislative instruments include a suite of ASIC Class Orders and Regulatory Guides and APRA's prudential framework including Prudential Standards and Practice Guides in addition to ACCC and Office of the Australian Information Commissioner (Privacy laws).

An outworking of this complexity is evident in the costs of updating regulatory disclosures. As a consequence of reviews to a number of pieces of legislation, significant updating of insurance disclosure documents is required during 2014. Changes must incorporate new provisions stipulated across the:

- *Insurance Contracts Amendment Bill 2013*;
- *Privacy Amendment (Enhancing Privacy Protection) Bill 2012*; and
- *Stronger Super* reforms.

Most of the resulting updates to disclosures have little impact on consumer protection outcomes, yet have required significant resources to review, assess and implement necessary changes. These costs will be incurred by every life insurer, with costs to Westpac in 2014 estimated at $3 million for *Insurance Contracts Act* changes alone.

This high compliance cost and unnecessary burden on the industry inhibits innovation and adoption of new technology. Simplifying and streamlining the legislation applying to life insurance will enable the industry to be confident that they are meeting the requirements deemed appropriate for consumer protection.

Greater alignment across different insurance licensing and product regimes

Greater alignment of legislation across different licensing regimes for life, health and general insurance will reduce arbitrage opportunities and ensure products are able to best meet consumer needs.

There are numerous shortcomings from the current segmented nature of insurance licensing and regulation. For example, life insurers currently manage return to wellness through rehabilitation programs, without the ability to fund medical treatment which requires a health insurance license.

A better outcome for consumers could be achieved if life insurers are able to incorporate some medical expense reimbursement to assist in a speedy recovery. Similarly, life insurance trauma benefits could provide support through indemnifying medical costs, as part of the benefit.

6.8.4 Complex taxation provisions

Complex taxation requirements place a significant compliance burden on insurers, whilst creating arbitrage opportunities between structuring of insurance arrangements either within or outside of the superannuation system or between different ownership structures such as a company or trust.

The complexity is evident across multiple dimensions:

Stamp Duty

Stamp Duty requirements differ by State, creating significant administrative complexities due to varying contract definitions, grandfathering provisions, tax rates and scales. By way of example, a TPD rider to a Term Life policy in Queensland would face a stamp duty rate of 9% per annum applying from 1 October 2013 for new contracts, but not for alterations to existing contracts. In New South Wales, the same policy faces an upfront 5% rate in year one for all policies for all new benefits, regardless of contract commencement.

At a minimum, harmonisation of stamp duty provisions across States will limit the volume of different requirements which must be interpreted, built into systems and passed through to customers. This would enable consistent treatment of consumers across States, improving efficiency to drive affordability of cover. This matter should be further considered under the tax white paper process expected to commence later this year.

Structuring insurance inside or outside superannuation

Discrepancies in tax treatment between life insurance policies purchased within or outside of superannuation cloud the determination of the structure that will best meet consumer's needs. This creates complexity for individuals and advisers and can result in poor consumer outcomes as needs change over time.

Consideration should be given to removing these anomalies and providing for more consistent tax treatment between superannuation and non-superannuation policies, and between policies held within superannuation but in different member accounts.

Expanding the definition of a member's tax free component to include proceeds from life and TPD insurance policies would remove the above complexity and align the taxation of superannuation held policies with those held outside the superannuation environment. If this is not feasible, at a minimum, consideration should be given to removing the untaxed component calculation in respect of life insurance structured inside superannuation.

Importantly, any modeling of the revenue implications of insurance tax reform needs to factor in the significant offset to government of more Australians being appropriately insured.

Recent KPMG analysis shows that every dollar of income received from private insurance can be expected to reduce the DSP by 50 cents through reduced eligibility.[1]

1. KPMG, Underinsurance – Disability Insurance Protection Gap in Australia, 2014.

CHAPTER 6
BUILDING AND PROTECTING AUSTRALIA'S WEALTH

6.9 THE EXPORT OF FINANCIAL SERVICES

6.9.1 Introduction

With the rapid growth in the size of Australia's superannuation industry since Wallis, Australia now has the third largest pool of managed funds in the world. More than $2.2 trillion is under management. Yet Australia only exports 3.5% of its funds management output — and only $77 billion is sourced from overseas investors and managed in Australia. As well as numerous economic benefits from growing our financial services sector, increased levels of foreign (portfolio) investment into Australia represent an additional funding source for the economy.

In January 2010, the '*Australia as a Financial Centre: Building on our strengths*' report (Johnson Report) was released with bipartisan support. From a funds management perspective, the Johnson Report made three critical recommendations:

- Allow the creation of alternative flow-through investment vehicles beyond unit trusts. This matter was referred to the Board of Tax;
- Introduce an Investment Manager Regime (IMR) with wide application to both retail and wholesale funds, and to other areas of financial services beyond funds management; and
- Develop an Asia Region Funds Passport (ARFP) to allow managed funds to be offered to investors in the region.

These recommendations remain incomplete. At the same time, competitor economies continue to pursue policy initiatives aimed at enhancing their competitive positions. Therefore, Westpac urges the Inquiry to reaffirm the need for the Johnson report recommendations to be implemented.

6.9.2 Policy Options

Expanding the range of Collective Investment vehicles

In May 2010, the Government asked the Board of Taxation to review the tax treatment of Collective Investment Vehicles (CIVs), including whether a broader range of tax flow-through collective investment vehicles should be permitted. The review was completed in December 2011 but the report is yet to be released.

The need for broadening allowable investment vehicles to better align with the preferences of international investors is critical if Australia is to develop into an international financial services centre. A particular priority should be consideration of the introduction of a corporate CIV with flow-through taxation.

Many foreign investors do not come from a common law jurisdiction. Consequently, these investors are not familiar with the trust investment structure used by Australian fund managers. Often, foreign investors prefer to invest in a CIV which has either a contractual basis (e.g. an Irish common contractual fund) or is a corporate entity (e.g. a Luxembourg SICAV).

Allowing Australian based fund managers to service these clients from Australia through the establishment of alternative flow through vehicles, particularly for non-resident investors, will reduce the need for them to establish offshore CIVs for these clients in competing jurisdictions.

Investment Manager Regime (IMR)

The IMR has not been implemented in a manner which will achieve the original policy intent recommended in the Johnson Report. Issues with the current IMR are that it is:

- Incomplete – only a partial IMR has been legislated to date;
- Uncompetitive – conditions are not consistent with IMRs in other jurisdictions; and
- Complex – various eligibility tests have made the provisions overly complex.

In the absence of a genuinely competitive IMR, it is highly unlikely that Australian based fund managers will be able to attract a greater share of funds from offshore.

Asia Region Funds Passport

The introduction of an Asian Region Funds Passport (ARFP) in early 2016 will allow eligible Australian managed funds to be sold to retail investors throughout the region. It will also allow eligible managed funds from other participating Asia-Pacific economies to be sold in Australia.

Arguably, the best indicator of the likely future of the ARFP is the Undertakings for Collective Investment in Transferrable Securities (UCITS) framework in Europe. UCITS are said to account for around 70% of all funds available for distribution in the Asian region.[1] For the ARFP to succeed, it will need to be seen to be superior to UCITS and offer access to markets not accessible to UCITS funds.

Timetable

The ARFP 'Statement of Intent' signed in November 2013 by Finance Ministers from Australia, New Zealand, Singapore and South Korea outlines the timetable for the introduction of the ARFP.

Westpac supports the proposed timetable, which is achievable, but the ARFP represents a very significant opportunity that will require careful planning and promotion by Government and industry if it is to be a success.

From an Australian perspective, the success of the ARFP will depend on three key factors:

- Ability to leverage existing products and infrastructure;
- Competitiveness – as a product competing with domestic and other foreign products; and
- Tax certainty and efficiency for foreign investors and Australian managed funds.

Existing products and infrastructure

Irrespective of the regulatory relief afforded to Australian based fund managers by the ARFP, there will be costs involved in offering a product into a foreign market. These costs will principally comprise marketing, distribution and administrative/operational support.

Rules which are overly restrictive and make it difficult for existing products to be offered will result in far fewer products being offered due to the greater costs involved in manufacturing a product solely for ARFP purposes. Key restrictions/eligibility requirements may include:

- Specific rules regarding any minimum amount of funds under management which must be sourced from ARFP economy investors; and
- Overly narrow investment rules – particularly in relation to eligible assets and/or undue restrictions on currency hedging.

These forms of eligibility requirements should be avoided to ensure the benefits of the ARFP are not significantly eroded.

Competitiveness

Fund managers will assess the competitiveness of the ARFP against domestic funds (in the host market) and UCITS funds. It is therefore critical that the ARFP not contain limitations, such as investment restrictions, which go beyond those for local funds and/or UCITS funds. Local distributors will not offer ARFP funds if they are more difficult to distribute.

Ongoing monitoring will be required to ensure that individual economies are not placing additional administrative barriers to the distribution of ARFP funds as a means to strengthen the position of local funds.

1. http://www.ucitsxxv.eu

A key determinant of the success of the ARFP is the number and size of participating economies. Before the ARFP commences, Westpac encourages the Australian Government to pursue the inclusion of China, which has a $420 billion managed fund market, and Japan, an existing and substantial cross border investor in Australia.

Tax certainty and efficiency

Given the investment choices available to foreign investors, tax certainty is essential. If Australian based fund managers are unable to provide ARFP investors with the same after-tax outcome as fund managers based in other ARFP economies, Australia's competitiveness will suffer.

Prior to the commencement of the ARFP it will be necessary to:

- Review Australia's Double Tax Agreements with ARFP economies;
- Determine whether Australia's Withholding Tax rates are in line with those in the region; and
- Ensure that, even in the absence of an expanded CIV regime, existing managed funds are able to efficiently manage multiple currency classes without compromising the tax outcomes of investors in different classes.

6.10 FURTHER TAX MEASURES ENHANCING INTERNATIONAL COMPETITIVENESS

Westpac believes the Inquiry should consider a number of tax reform proposals which will support the international competitiveness of Australia's financial sector. Suggested measures include maintaining an approach to transfer pricing which is consistent with OECD standards, having clear rules which give effect to the policy intent behind the Offshore Banking Unit regime, and ensuring that the controlled foreign company rules do not impede financial activities carried out overseas by Australian residents.

Westpac notes that the Government will initiate a white paper on tax reform during its first term. This is the appropriate forum to consider tax arrangements that affect the economy more broadly.

6.11 CONCLUSION

The continued growth of the superannuation system will be a critical element of the financial system's support of consumers and the Australian economy. The growth of the industry makes it imperative that the regulatory, governance and market structures of the industry optimise its continued growth in a way that is efficient, resilient and adaptive to innovation.

Further, if the insurance industry is to properly support the Australian economy and Government, an appropriate vision is required which informs the policy settings affecting the industry's ability efficiently and effectively manage risk. Government and industry should work together to develop such a vision.

Finally, the overarching objective of developing Australia into a leading financial centre in the region will only be achieved through a centralised and coordinated approach. This will ensure the wide range of tax and regulatory impediments are addressed in a timely and consistent manner.

Westpac GROUP

Recommendations

Westpac recommends the Inquiry:

- Reinforces the objective of the superannuation system to aim to deliver up to 65-70% of income replacement in retirement for all Australians;
- Strengthens the regulatory, oversight and governance structures of the superannuation industry;
- Considers measures to address the underinsurance gap by:
  - Removing unnecessary tax complexity;
  - Improving affordability through mitigating against natural disasters;
  - Breaking down barriers across various types of insurance; and
  - Addressing disincentives to insure.
- Considers measures to implement, and build on, the recommendations of the Johnson Review.

CHAPTER 7
DEVELOPMENTS IN TECHNOLOGY AND PAYMENTS

7.1 INTRODUCTION

Financial services are increasingly being delivered through technology, with face to face and voice based services expected to decline, perhaps even more rapidly than currently being anticipated. This is a secular change being driven by inexorable customer preferences.

The transition to digital and mobile interactions has broad impacts for financial services providers. The nature of mobility creates opportunities to change the customer experience paradigm in new ways. New technology advancements and techniques, such as cloud computing and big data, have also emerged to deal with the key challenges of financial services increasingly being delivered through technology. These challenges include managing technology infrastructure, as well as the volume of information and the speed of its creation

A strong financial system must first recognise, and then facilitate and promote this change. Partly this will occur through actively encouraging further innovative use of technology, and partly by removing existing behavioural barriers to technology adoption, which are more appropriate to a physical world. The financial system regulatory framework is an important element of the system's ability to facilitate and promote innovation through technology change.

7.2 TRENDS IN TECHNOLOGY INNOVATION AND FINANCIAL SERVICES

7.2.1 Westpac Group

Westpac has been a leader in bringing the benefits of technology to customers:

- In the 1980s Westpac introduced the first national electronic banking system – Handyway;
- In the 1990s Westpac was the first bank in Australia (and the second in the world) to launch internet banking;
- In the 2000s Westpac was the first bank to offer an iPhone application enabling customers to locate their nearest ATM; and
- In 2010 Westpac was the first bank to offer an iPhone application to help customers search for their new home.

Westpac continues to innovate. With the security of customers' information never more important, Westpac is the only major bank to use an on-screen login keypad for online banking services, reducing the risk of customers' details being compromised. Westpac was the first major bank to offer account opening for personal credit cards and loans through mobile applications. Westpac continues to bring the benefits of mobile technology to customers.

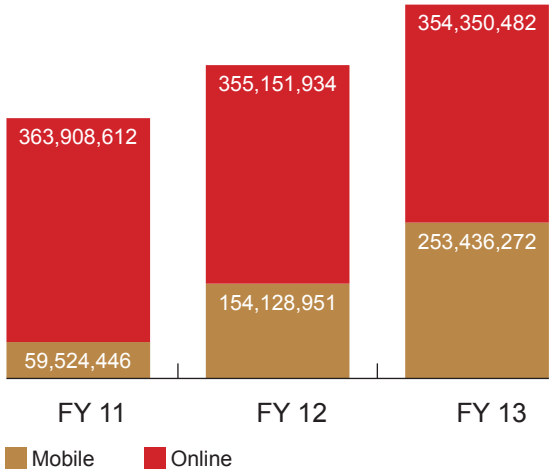
7.2.2 Digital and Mobility

Mobile channels are increasingly being used by customers to access financial products and services.

Mobile devices are rapidly being adapted to traditional banking areas, such as the growing use of mobility and location based services including Near Field Communications payments and ATM finders. These capabilities enhance the efficiency of the provision of financial services and the experience of customers. Further, customer take up of these innovations translates into a diminishing requirement for cash, particularly in branches.

Westpac's customers are increasingly using online and mobile services, with the proportion of mobile use rising significantly between 2011 and 2013. This is illustrated below with reference to the total online and mobile sessions in Westpac's Australian Financial Services (AFS) Division during this period.

Figure 7.1 – Online and Mobile sessions, Westpac AFS



The introduction of increasingly sophisticated mobile devices has lead to a trend of "consumerisation" of financial services; innovations are now being introduced around the individual needs of consumers, rather than the needs of large organisations or governments. As a result, customers have become increasingly empowered, expecting their providers to match their preferences – rather than providers' own processes.

In financial services, this has primarily been seen in the introduction of mobile applications (apps). Apps are highly attuned to, and much more easily integrated into, customers' lifestyles.

Westpac has more than 45 apps across brands and for all technology platforms and devices. These span mobile and tablet banking, commercial payments and a broad range of mobile banker capabilities. These apps also serve to enhance financial education. For instance, Westpac's PayPig app allows parents to teach their children about saving by setting up savings goals, assigning chores to children, and allowing parents to pay their children from the app.

7.3 CHALLENGES AND OPPORTUNITIES ARISING FROM TECHNOLOGY

The technology trends outlined above will continue to drive change in Australia's financial system. These trends will provide both challenges and opportunities for the future of the system.

Many of the customer innovations introduced in the financial sector in recent years have come from regulated financial services providers, such as Westpac. This has enabled the introduction of these innovations while supporting customer protection and system resilience. This should remain the key objective in the way innovation is delivered in Australia's financial system. It is important that innovation can continue to be viable within the regulated financial system, and that excessive or outdated regulation does not push innovation into shadow sectors.

In achieving this objective, the three key issues for the Inquiry to consider are:

- Ensuring that regulation of financial services does not unnecessarily inhibit the provision of innovation through technology;
- That the entry of new competitors does not compromise customers' confidence in the financial system, and the system's stability; and

- That the security risks associated with technology innovation, which in many ways are new and emerging, are appropriately managed.

Westpac believes these issues are best managed through a comprehensive strategy to ensure the financial system's regulatory framework supports technological innovation, while managing potential risks. Westpac recommends the Inquiry endorses the development of this strategy by Government in close consultation with financial sector participants.

7.4 ENSURING REGULATION ENABLES INNOVATION

Regulation should be designed to enable, and not hinder, the introduction of new technologies in financial services. This will support continued efficiency enhancements, and enable organisations such as Westpac to improve customers' experience of financial services.

7.4.1 Current regulation of technology in financial services

In applying technology to the provision of financial services, Westpac is currently subject to obligations from a number of sources. As an ADI, Westpac is subject to prudential standards and guidance relating to the management of security risk in information technology, as well as data risk and other associated controls.

Westpac is further subject to other general obligations that relate to the management of security and data risk, including Sarbanes-Oxley obligations and PCI payment card industry standards. In addition, financial services providers are subject to legislation that governs communications to customers and their information. This includes the National Credit Code, the *Electronic Transactions Act*, the *Privacy Act* and *the Corporations Act*. The *Anti-Money Laundering and Counter-Terrorism Financing Act* also sets out obligations regarding the identification of customers and the management of money laundering risk.

To ensure compliance with these various obligations, Westpac invests significant resources in the implementation of internal compliance controls. While this increases the cost of doing business, these controls are critical in ensuring the security of customers' transactions and information.

7.4.2 Potential enhancements to regulatory framework

Regulation

In many cases, existing regulation impacts the ability of regulated institutions to fully satisfy customer demand for innovation. This can lead to a 'disconnect' between the way in which many customers are choosing to communicate with their financial providers (through digital means) and the way in which financial providers are obligated to communicate with them in return (through paper or personal means).

There are numerous examples of potential enhancements to the regulatory framework that would facilitate greater enablement of technology innovation including:

- The modernisation of disclosure requirements to reflect emerging technologies. This includes increasing the ability of institutions to utilise electronic communications (for example, e-customer disclosure statements and notices and variations to terms and conditions) which would result in business efficiency gains, reduced paper usage and improved customer experience;
- Exploring opportunities for oral consent or digital signatures to replace written consent, including in areas such as the provision of debit cards to customers; and
- Enabling more opportunities for electronic identification and verification, thereby allowing customers (where appropriate) to have an 'end-to-end' digital interaction.

As part of the development of a comprehensive strategy for regulatory support of technology innovation, Westpac recommends the Inquiry commissions a review of disclosure and ongoing communications requirements for financial products and services to ensure they can be conducted electronically where appropriate.

Financial System Regulators

As the impacts of technology are typically not 'black and white,' a collaborative approach with financial system regulators, rather than prescriptive measures, is fundamental in ensuring innovation can continue to be made available to customers within the regulated system. Supervisory agreement to 'pilots' of new technologies – that would test their functionality and resilience with a small sample of customers – is an example of this collaborative approach that Westpac supports and which has been effective to date.

7.5 MANAGING RISKS OF EMERGING TECHNOLOGY

There are system resilience and customer protection risks associated with the emergence of new technologies in financial services. Regulatory and security measures should appropriately protect customer funds and information.

7.5.1 Regulatory support of competition and stability

The application of technology to financial services supports innovation and the entry of new competitors that may operate outside the regulated system. Westpac supports this competitive tension, but policy makers must remain cognisant of the need to maintain customer confidence in the financial system, and its stability.

Non-regulated organisations are providing more technology-based financial services, in areas such as the payments system. Poor or uneven regulation can allow some participants to build businesses through 'regulatory arbitrage,' where a lack of regulation and oversight provides the basis for business models. Any disruption to a service resulting from inappropriately regulated participants could lead to a major loss of confidence in the financial system and economy overall.[1]

Westpac believes the optimal way of managing these risks is to ensure that financial services are subject to the same customer protections and other regulatory stability protections, regardless of whether the providers of those services are otherwise regulated or unregulated, financial or non-financial companies. The regulatory framework applying to the financial system should reflect this principle.

7.5.2 Cyber-crime and security

Digitisation in financial services can provide more opportunity for criminals to undertake fraud. Attempted fraud against Westpac now exceeds $500 million per annum, which is anticipated to grow towards $1 billion per annum within the next five years. This is an industry-wide phenomenon.

The need for ongoing management of these threats is one of the chief objectives of Westpac's technology investment. Westpac has a dedicated Information Security Group ('ISG') that proactively engages in strategic technology plans, and for the monitoring and management of all the security threats that we encounter.

Given the vital role the financial system plays in the broader economy, cyber-crime needs to be treated as a matter that affects security at a national level. In addition to the risk of customer funds and information being compromised, cyber-crime has the potential to impact on the public's confidence in the financial system.

1. ABA. Financial System Inquiry Submission, at chapter 6.

CHAPTER 7
DEVELOPMENTS IN TECHNOLOGY AND PAYMENTS

Recognising the importance of cyber issues many countries, including the US and UK, have prioritised a national-level policy focus on cyber security. Australia needs to also prioritise these issues by undertaking a comprehensive review and update of its National Cyber Security Strategy. In addition, the strategy for cyber security should consider ensuring compliance with anti-money laundering and 'Know Your Customer' regulations, in particular for new participants that may not otherwise be subject to those regulations.[1]

7.6 AUSTRALIA'S PAYMENTS SYSTEM

The payments system is an important component of the financial system. By facilitating the settlement of payments for goods and services, it is vital to the financial system's support of the real economy and the day to day needs of customers.

Australia is best served by a stable, operationally resilient payment system where fraud is minimised, and where customers' stores of value are highly secure. The payments system currently meets these needs effectively, and it is important that it continues to do so.

7.6.1 Developments in payments since Wallis

Since the Wallis Inquiry, improved technology has supported significant improvements to customers' experience of payments transactions. Much of the innovation in payments has been driven by infrastructure created by major banks, which is available to other providers and which has supported new entrants.

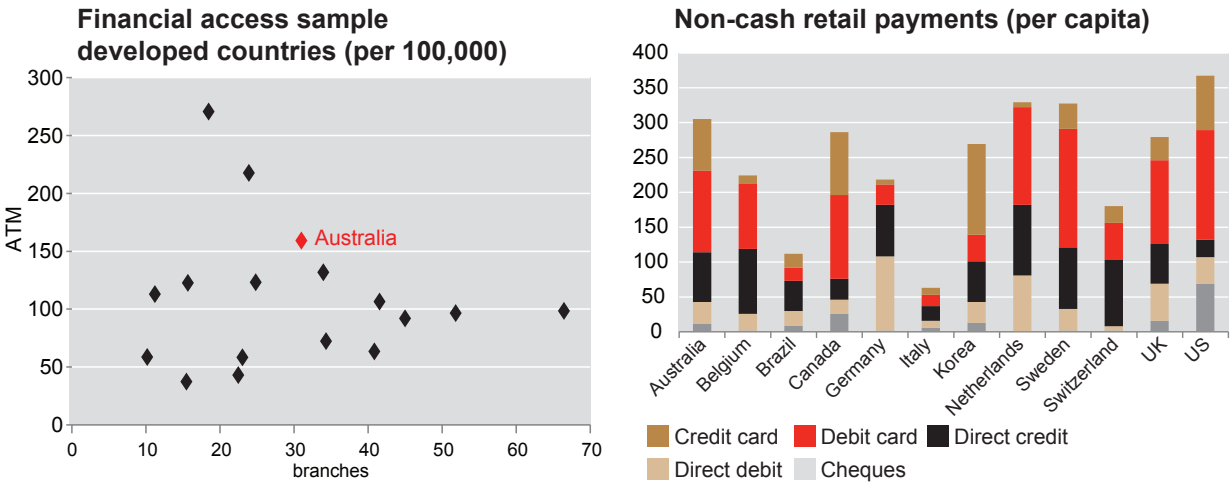
Cash remains the predominant form used to make payments, particularly for small amounts. RBA surveys indicate that around 80% of payments for under $25 are made by cash. However, the importance of cash in the payments system is declining, with ATM withdrawals trending down since 2010.

Growth in credit card payments was particularly strong in the early years following Wallis, although subsequently debit cards have enjoyed stronger growth. By value, the largest payment methods are direct credit (just under 50%), and direct debit (just under 40%).

Australia is well served with access to different physical payment platforms. Points of access have increased by over 9% annualised since 1997, with significant increases in ATMs and EFTPOS terminals. The number of non-cash retail payments per capita in Australia is high by international standards, as is ATM access. The number of bank branches is around the average for peer countries, although the importance of branches for payments is declining as more convenient digital and channels have been developed.

1. ABA .Submission to the Financial System Inquiry, Chapter 6.

Figure 7.2 – Comparison financial access (ATM and branches) and per capita non-cash retail payments



Source: Payments System Board Annual Report 2013, World Bank Global Financial Development Database. Non-cash payments data is for 2011. ATM and bank branch data is for 2010. Sample countries for non-cash retail payments in the chart on the left are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Korea, Netherlands, New Zealand, Singapore, Sweden, Switzerland and the UK

7.6.2 Current Regulatory and Industry Structure

The regulatory and industry structure of the payments system effectively provides for resilience, efficiency and competition through the system.

The RBA's Payments System Board (PSB) has the role of promoting the safety and efficiency of the payments system. The Australian Payments Clearing Association (APCA) is the self-regulatory body established by the payments industry to promote the safety, reliability, equity, convenience, and efficiency of the payments system. APCA's focus is to promote innovation and competition in the Australian payments system.

Evidence of the successful operation of the payments system regulatory infrastructure is the process which established the New Payments Platform (NPP), welcomed by the PSB. In this case, the PSB specified changes to the payments system that it viewed as being in the public interest. The payments industry responded with a plan that sought to deliver those changes in a commercially sustainable manner. The NPP consists of:

- A new Basic Infrastructure (BI), which will link ADIs via an agreed network, enable fast switching, faster interbank settlement (via Exchange Settlement Accounts) and consider a new simplified payments addressing function; and
- Overlay Services that will vie for ADIs' business by leveraging the BI and providing compelling and profitable services that can be offered to ADI customers.

This new approach will promote competition and drive innovations in payments services, and will be equipped to meet the evolving needs of Australians in the digital age and beyond. It involves significant investment from the industry, and is a significant component of Westpac's compliance-driven project investment.

7.6.3 Maintaining consumer confidence in the payments system

As outlined in Section 7.5.1, the application of technology to financial services has seen new entrants in the payments system, a trend that should continue. This competitive tension provides positive customer outcomes through the provision of innovation and choice.

In the specific context of the payments system, it is important that participation of new entrants in the system meets prudential requirements that protect customers' funds. Wherever a customer has a financial claim on a payments system participant, there should be a common form of prudential regulation regardless of the nature of the provider.

There are currently a series of requirements imposed by APRA for non-ADIs to meet in participating in the payments system including Providers of Purchase Payments Facilities and Specialist Credit Card Institutions. Despite PSB's 7 March 2014 announcement that it will seek Government support to remove these arrangements (via repeal of Regulation 4 of the Banking Regulations 1966), Westpac, along with APCA, supports their continuation.

Continued consumer confidence in the payments system, combined with the existing regulatory and industry framework, will enable the continued roll-out of innovation in payments that supports customer needs and increased productivity in the economy.

7.7 CONCLUSION

Customers are now the main driver of change in financial services. Their changing preferences are leading the direction of the industry rapidly towards digital interactions and the pace of that change is accelerating. A modern financial system must be ready to support these changing preferences and the transition from a physical to digital world. Innovation is fundamental in supporting this transition by removing barriers to technology adoption. It also improves customer choice and promotes market competitiveness.

The regulation of financial services needs to enable rather than hinder this innovation. Technology will be a key driver of productivity growth for customers and the system alike. However, the risks associated with new technology in financial services also need to be appropriately managed, for the benefit of consumers and the resilience of the financial system.

The financial system regulatory framework should enable market participants to facilitate and promote innovative new ways of doing business that align to customer demand. A comprehensive strategy to ensure the financial system's regulatory framework supports technological innovation is a vital step in supporting this goal.

Westpac GROUP

Recommendations

Westpac recommends the Inquiry endorses the development of a comprehensive strategy to ensure the financial system's regulatory framework supports technological innovation, while managing potential risks. This strategy should be developed by Government in close consultation with financial sector participants and for example include:

- A review of disclosure and ongoing communications requirements for financial products and services to ensure they can be conducted electronically where appropriate; and
- Updating and implementing the National Cyber Security Strategy to help improve security resilience for all industries, with greater public-private sector cooperation.

CONCLUSION

Australia's financial system has proved to be resilient, efficient and flexible in successfully meeting the needs of customers and the economy. Across various measures, it compares favourably with the financial systems of developed economies around the world. Our system has been a key contributor to the nation's sustained period of growth, and to the financial aspirations of many Australians.

This Inquiry presents an opportunity to create a plan that capitalises on the strengths of our financial system, appropriately mitigates any potential vulnerability, and ensures the system best supports the nation's growth and prosperity. The recommendations in this submission are Westpac's contributions to this plan.

Ensuring that the financial system best supports Australia's growth is a worthwhile and achievable goal for the Inquiry. Westpac will assist the Inquiry in working towards this goal in any way possible.

APPENDIX I
OPPORTUNITIES FOR STREAMLINING REGULATORY IMPLEMENTATION

1.1 Introduction

As indicated in Section 3.6 of Westpac's submission, there are three main areas where consideration could be given to streamlining the implementation of regulation in Australian by financial system regulators:

- Regulatory accountability and efficiency;
- Regulatory reporting; and
- Consultation and impact analysis processes for regulatory change.

We have outlined below a number of possible measures that the Inquiry could consider in each of these areas.

1.2 Regulatory accountability and efficiency

There are a range of options the Inquiry could consider to enhance the level of oversight and accountability relating to financial system regulators including:

- Giving the Council of Financial Regulators more formal oversight of financial system regulators;
- A regular public review of financial system regulators, led by the Council of Financial Regulators; and
- A public assessment process in which regulated entities and the broader community could share their views relating to financial system regulators' performance.

1.2.1 Development of regulatory risk appetite statements

It is important that regulatory enforcement and policy interventions focus on the most material risk issues in the financial system. To support this, the Inquiry could consider opportunities for the publication of risk focus areas and tolerances by financial regulators, which is consistent with accepted risk management practices.

As suggested by the Business Council of Australia, risk appetite statements (RAS) for regulatory agencies could be developed. These would set out their policy, enforcement and surveillance priorities and be closely linked to the proposed Government RAS.

The RAS could form the basis for the establishment of key performance indicators and other measures to assess financial system regulators' performance.

1.2.2 Governance of financial system regulators

There is an opportunity for the Inquiry to consider whether governance mechanisms for financial system regulators are delivering best practice accountability and efficiency. This could consider international comparisons.

For example, the newly formed Prudential Regulation Authority in the UK has adopted a structure comprising both internal and external (independent) members for its board. There may be merit in considering a similar approach for some financial system regulators in Australia.

1.2.3 Objectives of financial system regulators

There is an opportunity to incorporate lessons from the implementation of regulation since the GFC into the existing objectives of financial system regulators.

These objectives include that:

- Australian financial system regulation ensures that financial services providers remain internationally competitive;
- Domestic implementation of global initiatives is balanced and appropriate, having regard to the needs of Australians; and
- Regulators are committed to cooperate so as to reduce the potential for overlapping regulatory activity.

1.2.4 Timeliness of regulatory decisions

In situations where the general approach to regulation has been determined following industry consultation, Westpac believes the timeliness of regulatory decisions is important. There have been examples of capital instruments taking many months to be approved due to uncertainty as to how global rules might evolve and be implemented in Australia.

The industry would benefit from greater transparency in relation to the timeliness of regulatory decisions. This could be achieved through:

- Publicly available performance measures;
- Streamlining of regulatory relief processes; and
- Fast-tracking relief proposals where these are in the interests of consumers.

1.2.5 Reducing 'red-tape' regulatory burdens

Targets for the reduction in the regulatory burden at the lower end of the risk spectrum may incentivise regulators to reduce unnecessary burdens on business.

One practical example would be the removal of the specific separate identification numbers for licenses such as RSE, AFSL and ACL. They could be replaced with a simple statement that says the entity has the relevant licence.

1.2.6 Reducing regulatory overlap

Westpac's experience is that, increasingly, the boundaries between prudential and conduct regulators are being blurred. One example is that ASIC has asked the industry to participate in a systemic risk survey in relation to investment banking. Traditionally, systemic risk has been the purview of APRA and the RBA.

APPENDIX I
OPPORTUNITIES FOR STREAMLINING REGULATORY IMPLEMENTATION

1.3 Regulatory reporting requirements

The provision of reporting to financial regulators is an important tool in the appropriate supervision of the financial system. It is also one of the most significant areas of regulatory burden on financial services.

For example, Westpac is required to provide reporting to a range of authorities including APRA, ASIC, the ATO, the Australian Bureau of Statistics, the RBA and a number of other State and Federal agencies. Some reporting requirements duplicate other requirements and the utility to the public of some of the information being requested is unclear.

This is especially the case in relation to the new superannuation reporting requirements introduced as a result of the former Government's *Stronger Superannuation* reforms.

Regulatory reporting is data and technology intensive, requiring significant capital investment to meet the requirements. Westpac has supported the Standard Business Reporting Initiatives and other initiatives by regulators such as APRA to look at ways to reduce the reporting burden.

More can be done to develop a single Government reporting portal and to balance legitimate requirements on financial service providers with the public utility of the information being sought.

Further, superannuation data collected by regulators needs to be rationalised and should be limited to information needed for prudential supervision purposes, with greater consideration given to moving the frequency of reporting to an annual basis.

1.4 Consultation processes for regulatory change

Westpac believes that consultation and impact assessments for regulatory change should be more timely, consistent and transparent.

Financial services providers are often subjected to extremely short timeframes for consultation. As an example, providers were recently given a very short period to respond to proposed anti-money laundering rules for customer due diligence. Yet these rules may have a profound impact on service providers.

1.4.1 Regulatory Impact Assessments

Regulatory impact assessment would be beneficial for all major regulatory changes, including subordinated legislation such as APRA's Prudential Standards. Exemptions will always be necessary in exceptional cases, for instance where emergency rulemaking is required.

Regulatory Impact Assessments provide an opportunity to consider costs impacts not only to directly regulated institutions, but the long term effects of the introduction of the regulation on the system. This would include the costs of the provision of financial services by providers, and as ultimately borne by Australian consumers.

In undertaking this assessment, it is appropriate for the depth of impact analysis undertaken to be commensurate with the extent of the likely impact of the legislation.

1.5 Further measures for regulatory efficiency

1.5.1 Financial Product Disclosure

Westpac supports measures for the modernisation and consistency of product disclosure requirements. This would have the benefit of providing better disclosure to customers through ease of understanding and improved customer protection. It would also provide efficiency benefits for financial services providers.

Disclosure requirements that had their origins in the Financial Services Reform regime of a decade ago are becoming outdated in a financial services landscape. Customers want to open, transact on and more generally manage their financial products and services via the use of non-personal channels and mobile devices.

Traditional disclosure regimes are heavily process-based in terms of both the composition of disclosure information and the dissemination of that information to consumers, because each of these features of the regime are subject to relatively inflexible statutory mandates. This can generate a tick-the-box mentality towards compliance with those mandatory requirements on the part of financial products and services providers; consumers may respond to this with cynicism and disinterest.

A disclosure regime that caters for a more tailored, self-service approach to selected, relevant content via a range of media is likely to be significantly more effective and efficient in educating consumers about the important features of their financial products and services.

This would encourage consumers to actively inquire about those aspects of their financial arrangements that are of key relevance to them.

1.5.2 Customer identification requirements

Significant cost and complexity underlies the correct verification of customers, noting that this is vital for anti-money laundering/counter terrorism financing purposes. Traditional methods of identifying and verifying customers are slow and can generate poor customer experience. They are prone to inaccuracy without significant layers of control being applied.

The Inquiry may consider the introduction of a single, secure national identification verification system akin to the New Zealand Government's RealME service which would be suitable as identification of individuals for anti-money laundering and counter-terrorism financing purposes.

Such a centralised electronic service would also have significant benefits for Government agencies. This is likely to require a user-pays model.

IBC

OBC