Westpac GROUP

WESTPAC'S RESPONSE TO THE FINAL REPORT OF THE FINANCIAL SYSTEM INQUIRY

Westpac Banking Corporation

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Executive Summary

The Westpac Group (Westpac) welcomes the opportunity to respond to the recommendations of the Financial System Inquiry's Final Report (Final Report).

The Inquiry is an important endeavour in ensuring that the financial system continues to support Australia's growth. Westpac's contribution throughout the course of the Inquiry has focused on the important structural changes affecting the financial system, including:

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

The Final Report comprehensively considers many of these changes and Westpac supports the majority of the Inquiry's recommendations. The recommendations provide a blueprint for Australia's financial system that will assist policy makers, now and in the future, in helping to ensure that the system continues to best support Australia's growth. Of these recommendations, Westpac believes the Government should prioritise:

- Ensuring the superannuation system meets the needs of Australians through clarifying its objectives, improving competition and governance standards, and supporting the retirement needs of all Australians;
- Improving consumer outcomes, including through better product disclosure, strengthening product issuer and distributor accountability and initiatives that raise the competency of financial advisers; and
- Supporting strong, independent and accountable regulators to help maintain trust and confidence in the financial system.

Ensuring the superannuation system meets the needs of Australians

While the current superannuation system operates on sound principles, the size of Australia's superannuation savings, and demographic change, necessitate a clear and unequivocal objective for the future of the system.

Westpac supports the Inquiry's recommended objective for superannuation, being to *'provide income in retirement to substitute or supplement the Age Pension,'* and that the objective is enshrined into legislation. A framework should be developed to dimension or phase the level of retirement income and its duration. Wide-ranging consultation on the elements of this framework is critical. Potential elements of this framework could include:

- A target income replacement rate of 65-70% for all Australians, up to an agreed multiple of Australia's average weekly earnings. This would support the most efficient allocation of tax concessions for superannuation and Age Pension support;
- An example of a phased approach to retirement income could be:
  - Phase 1 to focus on the delivery of a flexible income stream of 65-70% income replacement (with access to capital) from retirement age up to mean mortality age (the 'active stage'); and
  - Phase 2 to focus on a stable or guaranteed income above mean mortality age (the 'frail stage') to protect against longevity risk; the income stream having been pre-purchased at the point of retirement where the cost is cheaper and risks can be pooled.
- To effectively address the issue of Australia's ageing population and longevity risk in superannuation, consideration should be given to defining the age of eligible access to the Age Pension and superannuation based on a percentage of Australia's mean mortality age.

The combination of the Stronger Super reforms and the introduction of an open competitive MySuper market will deliver substantial efficiency benefits during the accumulation phase of superannuation. A review into the performance of the MySuper reforms in 2020 against their intended objectives would be positive. Furthermore, the Inquiry's recommendation to strengthen governance across the superannuation sector is welcome.

Westpac endorses the Inquiry's recommendation for trustees to pre-select a comprehensive income product for members' retirement. As the Inquiry proposes, at retirement the member would either give their authority to commence the pre-selected option or elect to take their benefits in another way. The proposed comprehensive income product should be principles-based and supported by an integrated advice model. Development of guiding principles for the pre-selected product will require significant consultation between Government and industry, and Westpac will be actively involved in this process.

Improving consumer outcomes

Australia's consumer protection framework consists of a number of important elements including disclosure, law and regulation, advice, financial literacy and the culture of financial firms. Building confidence and trust in the financial system is an important objective, especially given the recent incidents of consumer loss from poor advice, and elements of the consumer protection framework should be improved.

Westpac supports the Inquiry's recommendation for the removal of regulatory impediments to innovative product disclosure and communication with customers, and to improve the way risk and fees are communicated. Current opportunities to improve disclosure include:

- The need for technology neutral language to ensure regulation keeps pace with emerging technologies without inadvertently restricting further development;
- Moving to ensure regulation of online disclosure is consistent across all financial products; and
- Confirmation that electronic delivery is the default mode of delivery.

Westpac supports the Inquiry's focus on strengthening the accountability of product issuers and distributors. The 'end-to-end' process of designing, manufacturing and distributing products and services should focus on doing the right thing for customers throughout the life of the relevant product or service. Product issuers and distributors should ensure that their products and services are designed to meet customers' needs and perform as promised, and customers should be provided with the information they need to make informed decisions.

Currently, a number of legal and regulatory mechanisms in Australia's consumer protection framework require this accountability. In turn, many product issuers and distributors reflect these requirements through their policies and governance arrangements for product design and distribution.

Implementation of the principles-based design and distribution obligation proposed by the Inquiry should be undertaken with clarity and simplicity, and help to streamline the mechanisms of the existing consumer protection framework. Clear and consistent legal and regulatory obligations will protect consumers, and give product issuers and distributors a strong framework in which to innovate and provide wide-ranging choice for customers, including as customers' needs and preferences change.

Westpac supports the Australian Securities and Investments Commission (ASIC) having a clear mandate, strong powers, and appropriate resourcing to effectively address consumer protection issues. ASIC currently has a wide range of powers to meet this objective. However, the resourcing and funding of ASIC to most effectively use its powers should be improved to support the regulator's ability to execute its mandate (discussed further below).

The Inquiry has proposed a further proactive ASIC intervention power. There is an opportunity to design the power with clear accountabilities and a targeted scope, focused on those areas where ASIC's current powers are shown to be clearly inadequate.

The Government's response to the Final Report, and to the recommendations of the Parliamentary Joint Committee on Corporations and Financial Services for increasing the professional standards of advisers, presents an important opportunity to bring together a cohesive, overarching approach to improvements in industry standards of financial advice. The principle of greater alignment of the interests of financial firms and consumers, and raising the competency of advisers, is one which Westpac strongly supports. Specifically, this should include:

- Raising standards of conduct and levels of professionalism to build confidence and trust in the financial system. The implementation of a new national professional standards framework for advisers who provide personal advice to retail clients would be an effective way to promote confidence and trust in financial advice. This should include raising standards across conduct, formal education and competence to meet community expectations; and
- Expanding ASIC's powers to include the ability to ban an individual from managing a financial services business.

Supporting strong, independent, accountable regulators

The objective of ensuring Australia's regulators have the funding, staff and regulatory tools to deliver effectively on their mandates is critical and Westpac supports the Inquiry's recommendations for:

- Providing regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews;
- Increasing their capacity to pay competitive remuneration;
- Boosting flexibility in respect of staffing and funding; and
- Providing clearer guidance to regulators in Statements of Expectation.

The introduction of an industry funding model for ASIC should follow consultation with industry and be fairly attributed, with fees closely aligned to the cost of regulating. It should also be strongly linked to:

- More transparent budget setting with extensive stakeholder consultation and final approval by the Government;
- A risk-based approach to regulation so that expenditure or resources are not overly directed towards areas of low regulatory risk; and
- Increased accountability measures, such as creating a formal mechanism for Government to receive annual independent advice on regulator performance.

An industry funding model with these features should provide a sound pathway to enable ASIC to effectively deliver on its mandate.

The Inquiry's recommendation for increasing the time available to industry to implement complex regulatory change is welcome. This would be an effective mechanism through which to reduce costs, complexity and unanticipated negative implications associated with implementing new regulatory obligations.

Recommendations needing further consideration

The Reserve Bank of Australia (RBA) noted in its recent Financial Stability Review that *'a number of domestic and international policy initiatives, if implemented as recommended or proposed, would require banks to increase their capital positions further over time.'*[1] Both domestic and international proposals are directly relevant to future capital requirements for Australian banks.

Therefore, consideration of Recommendations 1 and 2 should be informed by the outcome of recent global capital proposals, which were announced by the Basel Committee on Banking Supervision (BCBS) after the release of the Final Report. The BCBS proposals interplay with key elements of the Inquiry's recommendations on unquestionable strength and the relativity of capital requirements between banks operating under the Advanced Internal Ratings-Based (IRB) and Standardised approaches. They are therefore directly relevant to the Inquiry's proposals.

[1] p.1, RBA, *Financial Stability Review,* March 2015.

Changes to Australian bank capital requirements should consider together the proposals of the Inquiry and the outcomes of the BCBS processes to ensure Australian requirements are aligned with global standards and to provide clarity for global investors and customers. This would also avoid unnecessary and inefficient duplication or re-work in transitioning from current to future capital requirements.

It is in Australia's economic interests that the ultimate changes to Australian bank capital requirements arising from current reviews should continue to motivate the regulated financial system to achieve and maintain an efficient risk-based approach to capital allocation. This best supports sustainable growth in the Australian economy.

Recommendation 1

Westpac agrees that the Australian banking system should be seen as strong. This assessment of strength should be viewed through all its dimensions, including capital, asset quality, risk management, balance sheet, quality of supervision and regulation, and franchise strength. Against these factors, the Australian banking system is currently very strong. Regulatory mechanisms and market scrutiny should ensure it remains so.

Westpac believes a requirement that Australian bank capital ratios are permanently in the top quartile of internationally active banks disproportionately emphasises only one facet of strength.

The top quartile capital requirement would also have a number of practical difficulties that are likely to cause market uncertainty and lead to a constantly 'moving target,' as capital targets would be more impacted by overseas regulatory developments that may be at odds with Australia's particular risks.

Should the Australian Prudential Regulation Authority (APRA) determine that the top quartile approach be considered, it will be important for banks to work closely with the regulator to ensure practical considerations are appropriately incorporated in the new requirement.

Rather than a top quartile requirement, the Inquiry's objective of strength should be satisfied through highly scrutinised, prudently managed and well-supervised banks, operating in an environment where APRA continues to set strong regulatory capital requirements that are consistent with global standards.

The supervisory framework for ensuring strength already exists, and further focus on the operation of that framework is preferred to implementing a permanent international capital benchmark.

Recommendation 2

Westpac acknowledges the need for relativity of regulatory capital requirements between Advanced IRB and Standardised approaches, within an efficient risk-based framework for allocating capital. These issues are currently being considered through the BCBS process, which is likely to result in greater clarity and closer relativity between the two risk approaches. Australia's banking industry is actively contributing to this work.

However, Recommendation 2 is based on an increase to Advanced IRB risk weights that is not commensurate to risk. This can distort the effective allocation and pricing of credit, and therefore reduce economic efficiency.

Furthermore, there is no strong evidence of how an increase to Advanced IRB risk weights would provide competitive benefits for customers in the already competitive lending market. Mortgage lending in Australia features a diverse number of providers and lenders.

The ultimate implementation of the BCBS proposals in Australia should be guided by two key principles:

1. The need to preserve an efficient risk-based approach to capital measurement and allocation; and
2. Recognition of the conservative nature of Australia's mortgage regulatory capital requirements and the strong features, and low loss experience, of the Australian mortgage market relative to most other jurisdictions.

Summary

As Australia enters an important new phase in its economic growth – with the development of innovative new businesses and greater reliance on the 'knowledge economy' – the effective operation of the financial system will be more important than ever.

To most effectively support Australia, the financial system must be resilient, efficient and flexible, as it drives, responds and adapts to these emerging trends.

The Inquiry's recommendations deliver a valuable roadmap for policy makers to test the system's performance against these measures. This is a perpetual process of improvement, ensuring that the system is constantly evolving to meet the needs of its stakeholders.

Westpac supports the Government in reforms that will help customers, communities, and the nation, to prosper and grow.

Chapter 1 – Resilience

Recommendations 1 and 2

Capital levels

Set capital standards such that Australian authorised deposit-taking institutions are unquestionably strong

Narrow mortgage risk weight differences

Raise the average IRB mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.

Introduction

Westpac believes that consideration of Recommendations 1 and 2 should be informed by the outcome of recent global capital proposals, which were announced by the BCBS after the release of the Final Report.

The BCBS proposals interplay with key elements of the Inquiry's recommendations on unquestionable strength and the relativity of capital requirements between banks operating under the Advanced IRB and Standardised approaches. They are therefore directly relevant to the Inquiry's proposals.

Changes to Australian bank capital requirements should consider together the proposals of the Inquiry and the outcomes of the BCBS processes to ensure Australian requirements are aligned with global standards and to provide clarity for global investors and customers. This would also avoid unnecessary and inefficient duplication or re-work in transitioning from current to future capital requirements.

The two BCBS papers that most directly impact Recommendations 1 and 2 were released after the Final Report, on 22 December 2014:

- *Revisions to the Standardised Approach for credit risk* – proposing a revised approach for calculating standardised risk-weighted assets using a limited number of 'risk drivers' instead of external ratings and/or a flat percentage; and
- *Capital floors: the design of a framework based on standardised approaches* – proposing a capital floor for IRB banks based on the new Standardised approach.

The BCBS plans to complete these consultation processes in 2015, following which national regulators will implement changes in individual jurisdictions. New requirements will become clearer once these processes are completed.

In this submission, Westpac comments on key considerations relevant to finalising policy responses to Recommendations 1 and 2, following the outcome of the BCBS processes.

The risk-based approach to capital brings economic benefits

A risk-based approach is the most effective mechanism for determining and allocating capital and this approach should be retained. The Final Report states that changes in risk weight calculations *'should be achieved in a manner that retains an incentive for banks to improve risk management capacity.'*[2]

However, the capital changes proposed in Recommendations 1 and 2 tend to dilute risk sensitivity. Capital allocation that is unrelated to risk can create distortive effects in the provision of credit and impact the efficient allocation of resources in an economy.

A risk-based approach to assessing and managing capital, complemented by strong supervision, has served Australia well. APRA supports the risk-based approach and has stated:

'When we set capital requirements we look at three things: adequacy, because we want to be safe; incentive, because we want to match capital to risk; and simplicity. Those in the world who love leverage ratios love them because they allegedly produce adequacy, and they are certainly simple. But they utterly fail at incentives. So we very much want to keep a risk based approach to get that incentive effect...'[3]

Retaining the risk-based approach is important for Australia's economic prosperity. Banks' risk-sensitive models provide a means for an efficient mechanism to allocate credit. Where bank capital is linked to risk in a coherent and robust way, it will be allocated effectively and support economic growth in a long-term sustainable and stable way.[4]

As the Institute of International Finance noted[5], if the level of required capital assigned to different types of lending is not risk-based, then the incentive effect of matching capital to risk is eroded and distortions created. Such distortions would include:

- The risk of adverse selection, where a flat level of capital for assets of all credit quality progressively shifts bank portfolios towards higher-risk exposures, over-pricing credit for well-rated counterparties and under-pricing it for more marginal counterparties; and
- Higher capital requirements for lower risk-assets would mean regulated banks would struggle to compete against the 'shadow-banking sector'[6] for these stronger assets – skewing the portfolios of the regulated sector towards weaker credits. This also tends to increase systemic risk from the growth in the size of the unregulated shadow sector.

[2] p.60, FSI Final Report, November 2014.
[3] Charles Littrell, APRA, House of Representatives, *Official Committee Hansard,* Standing Committee on Economics, July 18, 2014.
[4] p. 5, *Risk Sensitivity: The important role of internal models,* Institute of International Finance, September 2014.
[5] Ibid at p. 6.
[6] As noted at p.24 of the RBA's March 2015 Financial Stability Review, shadow banking *'is defined as credit intermediation involving entities and activities outside the prudentially regulated banking system.'*

For these reasons, it is in Australia's economic interests that the ultimate changes to Australian bank capital requirements arising from current reviews should continue to motivate the regulated financial system to achieve and maintain an efficient risk-based approach to capital allocation.

Recommendation 1

Capital levels

Set capital standards such that Australian authorised deposit-taking institutions are unquestionably strong

Introduction

Westpac agrees that the Australian banking system should be seen as strong. This assessment of strength should be viewed through all its dimensions, including capital, asset quality, risk management, balance sheet, quality of supervision and regulation, and franchise strength. The Australian banking system is currently very strong when assessed against these factors.

Westpac believes a requirement that Australian bank capital ratios are permanently in the top quartile of internationally active banks disproportionately emphasises only one facet of strength.

The top quartile capital requirement would also have a number of practical difficulties that are likely to cause market uncertainty and lead to a constantly 'moving target,' as capital targets would be more impacted by overseas regulatory developments that may be at odds with Australia's particular risks. Should APRA determine that the top quartile approach be considered, it will be important for banks to work closely with the regulator to ensure practical considerations are appropriately incorporated in any new requirement.

Rather than a top quartile requirement, the Inquiry's objective of strength should be satisfied through highly scrutinised, prudently managed and well-supervised banks, operating in an environment where APRA continues to set strong regulatory capital requirements that are consistent with global standards. APRA has stated:

'In its supervision of capital management, APRA's focus is on ensuring that ADIs do more than simply meet minimum regulatory requirements. ADIs must demonstrate to APRA that they have built and can maintain buffers that reflect their specific risk profile and give them the capacity to absorb significant losses during any periods of stress.'[7]

The supervisory framework for ensuring strength already exists, and further focus on the operation of that framework is preferred to implementing a permanent international capital benchmark.

[7] p. 24, *Annual Report,* APRA, 2014.

Assessing strength on all its dimensions

The various dimensions of strength referred to above are in practice used by depositors, investors, credit rating agencies and other stakeholders when assessing banks' strength.

For example, Standard & Poor's (S&P) considers a number of factors in its bank rating methodology:[8]

- Factors relevant to a country's economic risk;
- Factors relevant to a country's banking industry risk;
- The business position, capital and earnings, risk position and funding and liquidity factors applying to a specific bank; and
- The extent of Group support or government support applying to that bank.

Australian banks rank well on these measures, with the four major banks among only 12 banks globally that are rated AA- with a stable outlook under S&P's methodology.

Excluding the effect of external support (such as implied government support) on these ratings, S&P has assessed that Australia's major banks have a stand-alone credit profile (SACP) superior to 68, and equal to 16, of the globe's top 100 banks. Only 12 of the world's top 100 banks have a higher SACP.[9] The SACP rates business position, capital and earnings, risk position, and funding and liquidity. This further demonstrates the strength of Australia's major banks on the broad dimensions of strength.

The GFC vividly demonstrated the importance of strong banks, and in response, Australian banks focused on increasing the quantity and quality of capital and increasing liquid asset holdings. For example, Westpac has:

- Increased its capital levels by around 40% since September 2007 (based on the increase in the total equity to assets ratio); and
- Managed a ten-fold increase in liquid assets. Westpac commenced the 2007 calendar year with around $14 billion in liquid assets, which has increased to $143 billion by December 2014.

As a result of these steps, and similar steps taken by other major banks, Australia's banking sector is significantly stronger than it was before the GFC.

Another key measure of strength - more resilient funding models

One of the Inquiry's policy objectives is to reduce vulnerability resulting from Australia's reliance on offshore capital. Following the GFC, Australian banks have already moved to enhance a stable funding profile that supports their continued operation through periods of global market volatility.

[8] p. 6, *Banks: Rating Methodology and Assumptions,* Standard & Poor's, November 2011.
[9] *Ratings Component Scores for the Top 100 Banks Globally,* Standard & Poor's, March 2015.

Westpac's stable funding ratio, reflecting the bank's funding composition by residual maturity, has risen from 64% in 2008 to 83% in the 2014 financial year. Specifically, the proportion of customer deposits to total funding has risen from 44% to 60%, and the proportion of wholesale offshore funding of a less than 12 month duration has fallen from 20% to 10% in the same period. Westpac has not only reduced its reliance on offshore funding since the crisis, but also increased the duration of its offshore funding.

Assessing capital strength on all its dimensions

During the Inquiry process, discussion often equated relative capital ratios with absolute strength. The Final Report's conclusion that banks should hold additional capital to be unquestionably strong is substantially based on this nexus:

'Evidence available to the Inquiry suggests that the largest Australian banks are not currently in the top quartile of internationally active banks. Australian ADI's should therefore be required to have higher capital levels.'[10]

While relative capital ratios are important, there are a number of other factors that determine capital strength and which either require or motivate banks to maintain strong capital levels. These factors include regulatory capital minimums, APRA's conservative approach to capital and supervision, sound bank risk management, the nature of banks' underlying risks and market expectations.

There has also been intense debate on the exact 'ranking' of Australian bank capital ratios compared with global peers. The variance of opinion on this issue serves to demonstrate the inherent difficulties associated with such international comparisons. APRA has stated: *'international comparisons are fraught with difficulty as data is not always available to properly compare 'apples with apples.' And there are a multitude of ratios – e.g. CET1, total capital and leverage.'*[11]

Independent analysis undertaken by PricewaterhouseCoopers found that the major Australian banks are well capitalised relative to both the global standards and with banks regulated in many other jurisdictions.[12] The analysis found that, on average, Australian major banks' common equity Tier 1 (CET1) capital ratios, on an internationally comparable basis, are at or above the 75th percentile of the most appropriate set of global banks.

APRA has stated that, after adjusting for differences in national application of the Basel standards, the largest Australian banks appear to be in the upper half of their global peers in terms of their capital strength. APRA's assessment, which incorporates the Basel Committee's monitoring data and APRA's own estimates of the necessary adjustments to risk-weighted assets, is that the largest Australian banks are broadly in the middle of the third quartile (i.e. above the median) of their global peers in their CET1 ratios.[13]

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[10] p. 41, FSI Final Report, November 2014.

[11] Footnote 1, *Seeking strength in adversity: Lessons from APRA's 2014 stress test on Australia's largest banks,* Wayne Byres, 7 November 2014.

[12] PricewaterhouseCoopers, *The international comparability of Australian banks' capital ratios,* Report to the Australian Bankers' Association, August 2014.

[13] APRA, *Seeking strength in adversity, lessons from APRA's 2014 stress tests on Australia's largest banks,* 7 November 2014.

The Final Report also found that Australian authorised deposit-taking institutions (ADIs) are generally well capitalised.[14]

Notwithstanding these discussions regarding relative capital ratios, evidence shows that Australian banks are strongly capitalised against a range of factors that determine capital strength. These factors are now discussed.

APRA's regulatory capital requirements

APRA sets minimum capital requirements for banks and, in the case of domestic systemically-important banks (D-SIBs), APRA requires additional capital (the D-SIB surcharge) to reflect their systemic importance to the financial system. In many instances, Australian banks have met minimum regulatory capital requirements in advance of implementation of the surcharge. For example, Westpac's preferred capital range (discussed below) already incorporates APRA's 1% D-SIB surcharge in advance of its commencement on 1 January 2016.

Australian regulatory capital requirements are conservative by global standards. APRA has stated that a hallmark of its prudential regime is its conservative approach to the definition and measurement of capital.[15] This conservatism is targeted at areas most relevant to Australian banks' circumstances – for example, APRA has imposed a floor of 20% on loss given default estimates for all mortgages, regardless of gearing.

Compliance with APRA's minimum regulatory capital requirements should already place banks in a strong capital position in terms of both their own risks and relative to the capital levels of global peers.

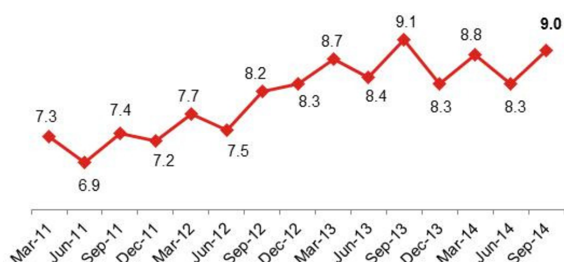
In practice, banks significantly exceed these regulatory minimums. This is a result of prudent bank management and a reflection of market discipline. Westpac's preferred CET1 capital range is 8.75%-9.25%, providing a significant buffer in addition to APRA's regulatory minimums. This buffer takes into account the capital conservation buffer (which includes the D-SIB surcharge), stress testing to maintain an appropriate buffer in a downturn and the quarterly volatility of capital under Basel III treatment of dividend payments. The elements of this range are shown in Figure 1.

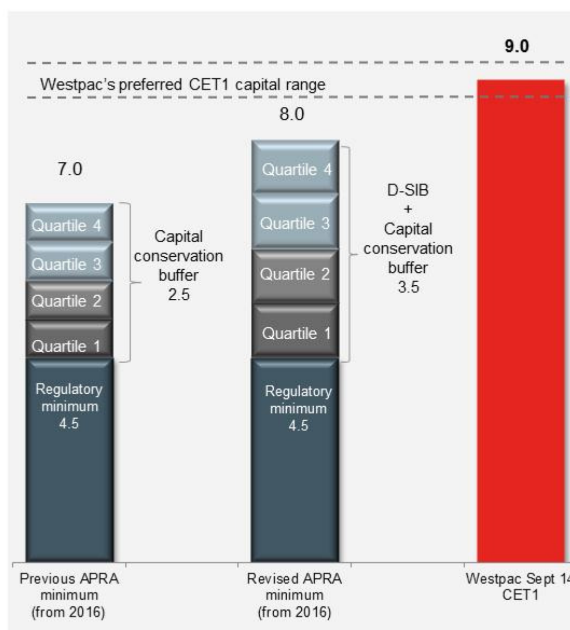
[14] p. 41, FSI Final Report, November 2014.

[15] APRA, *Information Paper Domestic Systemically Important Banks,* December 2013.

Figure 1 – Westpac's preferred capital range

- APRA have imposed a D-SIB[1] requirement of 1% to be met by CET1 capital. Implementation of the D-SIB requirement is through an extension of the capital conservation buffer (CCB) effectively increasing the buffer above regulatory minimums (commences 1 January 2016)
- Westpac's preferred CET1 capital range has been revised to 8.75-9.25%. The management buffer above regulatory minimums takes into consideration
  - Regulatory minimums and the CCB, including the 1% D-SIB requirement
  - Stress testing to maintain an appropriate buffer in a downturn
  - Quarterly volatility of capital ratios under Basel III associated with dividend payments





1 Domestic systemically important banks in Australia" Information Paper, December 2013, APRA.

Capital – 'adequate for what?'

Ultimately, the function of allocating capital is to provide adequate loss absorption given a specific institution's risks. As the Chairman of APRA has stated, the first question in discussions regarding capital adequacy is *'adequate for what?'*[16]

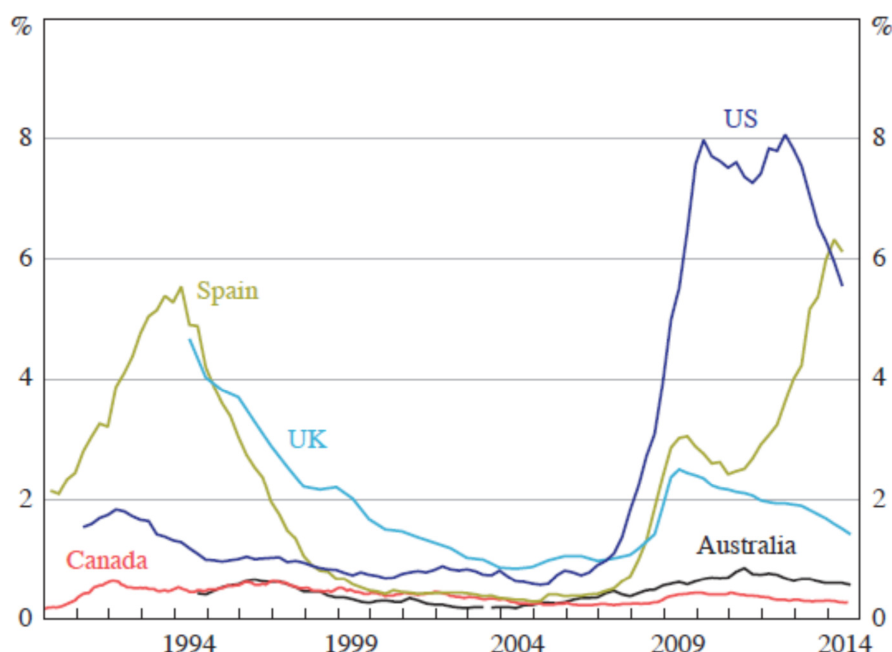
In Australia, banks' business models are simpler than in other jurisdictions and comprise largely retail and commercial banking operations. The focus of recent discussions has been on risk associated with Australian banks' large mortgage asset holdings. However, this is actually a strength of Australia's banking system.

Mortgage portfolios have a very low-risk of loss historically compared to other asset classes. They are a secured asset class and form diversified, granular portfolios with predictive loss characteristics that minimise the probability of sudden 'shocks.' The quality of these assets is also underpinned by strong structural features of Australia's mortgage market, including strong underwriting standards, the use of securitisation for funding rather than risk transfer (ensuring no incentive to dilute underwriting standards), high rates of partial prepayment of loans, full-recourse lending and the lack of significant 'honeymoon' period discounts on home loans, which were prevalent in some other countries.

Together, these features mean Australian banks' non-performing housing loans as a share of total housing loans have been, and continue to be, among the very lowest in the world. This is shown in Figure 2.[17]

[16] p. 1, *Seeking strength in adversity: Lessons from APRA's 2014 stress test on Australia's largest banks,* Wayne Byres, 7 November 2014.

Figure 2 – Banks' non-performing housing loans



Large Australian banks using internal models also calibrate their risk weighted assets conservatively to allow for potential downturns through a full credit cycle. For example, the observed loss rates across Westpac's portfolio are significantly lower than the modelled loss rates used to calibrate risk weighted assets. In the 2014 Financial Year, Westpac's regulatory expected loss for residential mortgages was $818 million compared with actual losses of $121 million for the same period.

Westpac regularly tests how the residential mortgage portfolio would perform through recession scenarios. In these stress tests, Westpac investigates the predicted impact from large house price decreases (26% cumulative drop), coupled with higher unemployment (up to 11.6%) and deteriorating Gross Domestic Product (down as much as -3.9% annual growth). This scenario is more extreme than what was experienced by the US and Europe during the GFC.

The analysis includes how the loan to valuation ratio (LVR) is impacted under the stress scenarios to ensure that the portfolio remains predominantly secured, and that customers can meet their mortgage payment obligations through measuring and monitoring the debt serviceability of mortgages.

Westpac maintains a conservative capital position versus historical and modelled losses. Figure 3 notes an expected loss rate of 0.32% in the mortgage portfolio under Westpac's internal benchmark severe recession scenario. The loss rates for the mortgage portfolio were 0.03% in Westpac's 2014 financial year. In the recession of the early 1990s, Westpac's loss experience was low, only reaching 0.11%. These loss rates compare with capital of 1.32% based on an indicative CET 1 ratio of 8.5%.

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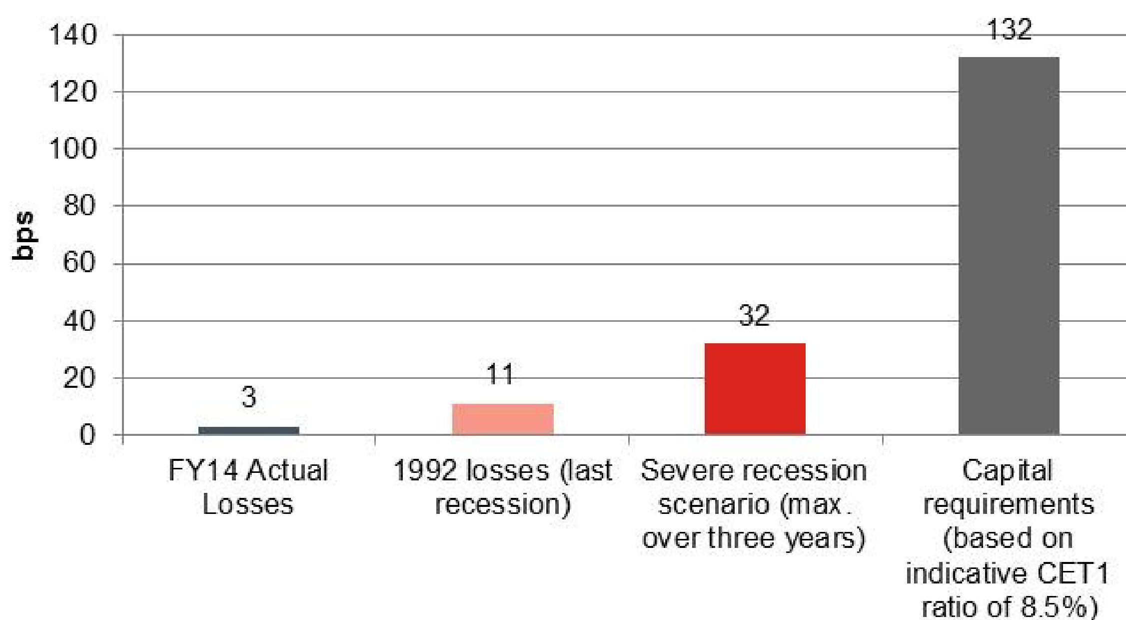
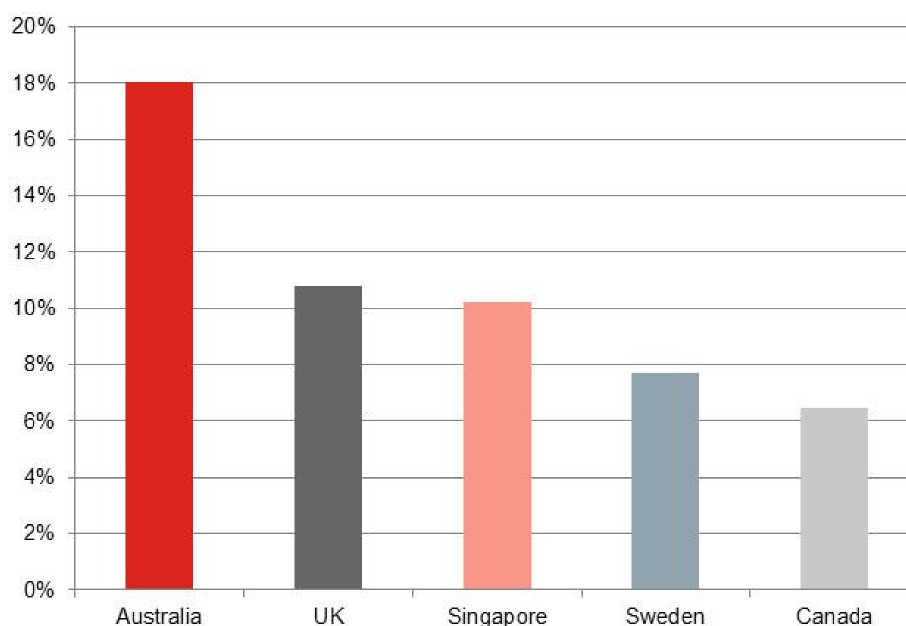
[17] p. 2, RBA, *Mortgage-related Financial Difficulties: Evidence from Australian Micro-level Data,* Research Discussion Paper, November 2014.

Figure 3 – Westpac loss rates for mortgage portfolio



As a result of this conservatism, and despite the strong features of Australia's mortgage market, Australian banks' regulatory risk weights for mortgages are among the highest in the world. This is shown in Figure 4.

Figure 4 – Average mortgage risk-weights by country, 2014[18]



(As US banks do not use the Advanced IRB approach analogous data from the US is not publicly available)

[18] Using Pillar 3 disclosures: Australia (ANZ, CBA, Macquarie, NAB, Westpac); UK (Barclays, HSBC, Lloyds); Singapore (DBS, OCBC, UOB); Sweden (Nordea, SEN, Svenska Handelsbanken); and Canada (Bank of Montreal, Bank of Nova Scotia, CIBC, Royal Bank of Canada).

As part of the recent BCBS capital-related announcements, the BCBS has proposed a number of measures to reduce excessive variability of regulatory capital derived from internally-based models (which are approved by regulators), including for mortgages. This work is continuing, complex and important. It is discussed further in Westpac's response to Recommendation 2.

Market discipline motivates capital strength

It is in banks' interests to maintain capital levels that exceed market expectations. Australian major banks are subject to intense market scrutiny of their capital levels and other measures of franchise strength. This acts as a natural mechanism through which banks must ensure their capital levels are strong, both in absolute terms and relative to global norms, particularly among banks raising wholesale funding from the same global institutional investors.

No market-based evidence has been presented to support the conclusion that Australian banks' capital requirements are inadequate or that the current levels and bank targets for capital holdings are likely to be an inhibitor to market access.

Experience through the GFC showed that, during a crisis, investors' decisions are impacted by global uncertainty. Australian bank capital levels were not an important consideration during the GFC. As extreme crisis passes, investor scrutiny turns to the assessment of risk, including extra focus on the issues that gave rise to the crisis (for example, liquidity risk or mortgage market failure). As such, while capital strength is important, singular focus on this element will not guarantee consistent market access. Banks need to manage all the elements of risk including credit exposure, funding quality and mortgage concentration – along with capital levels for loss absorbency.

Therefore, when access to global funding markets is constrained, for example in a liquidity crisis, it is unlikely that institutions with even the highest capital levels will be in a significantly more advantageous position to access funding. Maintaining the dimensions of strength referred to above will be relevant to access in these circumstances, not solely capital.

Practical limitations of a permanent top quartile capital ratio requirement

A permanent top quartile requirement presents a number of practical limitations as a measure of relative global strength. These issues include:

- It would be an inherently moving measure, creating continuing uncertainty for banks and market participants alike. There are a multitude of constantly changing regulatory and market factors that determine individual bank capital ratios globally;
- Movements of the top quartile measure will be determined largely by overseas regulators managing their domestic priorities, and may not reflect changed capital strength of banks. For example, Finansinspektionen (the Swedish Financial supervisory authority) imposed stricter capital requirements for Swedish banks in 2014, which were macro-prudential measures aimed at reducing systemic risks in the Swedish economy through increasing financial system resilience.[19]

[19] p. 45, *The Riksbank Monetary Policy Report*, 2014.

This shows how capital requirements of Australian banks could be impacted by the macro-prudential policy goals of an overseas regulator;

- Increased mortgage risk weights that may result from the BCBS processes would lead to (all other things being equal) higher capital holdings in dollar terms, but stable CET1 capital ratios – which does not reflect the true change in capital strength;
- The challenge of a truly harmonised base from which to compare capital ratios and for directly comparing one institution's capital ratio with that of another institution in a different jurisdiction. National discretions are used differently and widely by regulators in each jurisdiction. The Inquiry's recommendation of a reporting template for Australian banks that is transparent against the 'minimum Basel capital framework' would not provide an appropriate comparison of Australian capital ratios. This is discussed further in Recommendation 4; and
- Determining an appropriate sample set of banks. The Inquiry recommends the sample set should be 'internationally active banks,' presumably being banks against which Australian banks are actively competing for funding. This sample set of internationally active banks would need to be continually monitored and updated.

Should APRA determine consideration of a top quartile requirement is warranted, industry and the regulator should consult extensively to ensure these practical issues are comprehensively considered.

Recommendation 2

Narrow mortgage risk weight differences

Raise the average IRB mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.

Introduction

The current BCBS consultation is crucially important in determining changes to mortgage risk weights for Australian banks. The policy response to Recommendation 2 should only be finalised once the outcomes of the BCBS processes are understood. Its implementation ahead of the BCBS outcomes would lead to Australian IRB banks holding higher absolute capital levels, but relatively lower CET 1 ratios, compared with global peers that have not yet implemented risk-weight changes. This would reduce market transparency and understate Australian banks' strength.

Recommendation 2 proposes increased capital requirements unrelated to a change in the underlying risk of IRB banks. As discussed above, eroding the relationship between capital and risk can have distortive effects to the efficient allocation and pricing of credit.

Westpac acknowledges that there needs to be a level of relativity in regulatory capital requirements between the Advanced IRB and Standardised approaches to credit risk and work is underway globally to achieve this. Westpac is actively participating in this work. The ultimate goal of these reforms should be to enhance resilience and confidence in the financial system based on an efficient risk-based approach to capital allocation.

In this submission, Westpac addresses the two policy areas driving consideration of changes to mortgage risk weights through the Inquiry and BCBS processes:

1. Reducing the risk weight differential between Advanced IRB and Standardised approaches in the context of competitive neutrality. This is the focus of the Inquiry's recommendation; and
2. Reducing excessive variability in risk weights to improve resilience and confidence. This is the primary focus of the BCBS proposals. While not expanding on the technical aspects of the BCBS proposals, Westpac outlines key principles that should be applied to ensure Australia is not unfairly disadvantaged in the application of the BCBS requirements.

Each of these areas is now discussed.

Reducing the IRB and Standardised risk weight differential

There is no strong evidence demonstrating than an increase in Advanced IRB mortgage risk weights would provide competitive benefits for customers in Australia's already competitive mortgage lending market.

The Inquiry focused on the difference in mortgage risk weights between Advanced IRB and Standardised banks. This difference is often solely attributed to the benefits of IRB accreditation and ignores the inherent differences in risk that can arise between IRB and Standardised bank portfolios.

For example, the mortgage portfolios of the Australian IRB accredited banks are well-diversified across geographic and other demographic dimensions. Less diversified portfolios are subject to concentration risks that give rise to higher probability of risk of loss and require a higher rate of capital backing. Seeking to 'reduce the gap' without considering differences in risk profile has the potential to distort the allocation of capital to the risks in Australia's financial system.

Notwithstanding the above, Westpac has throughout the course of the Inquiry proposed that assistance should be provided to Standardised banks to obtain Advanced accreditation. This would remove any differences in risk weights that are unrelated to underlying risk, while allowing more sophisticated modelling to appropriately reflect the differences in the risk profile of lenders' mortgage portfolios. The Inquiry did not support this approach on the basis that it would place Australia outside the global norm. However, given changes likely to be proposed by the BCBS, the viability of this approach should be re-considered once these global changes are known.

Australia's mortgage lending market is diverse

Australia's mortgage lending market is diverse and subject to intense competition on a range of measures. The market offers broad product choice and a diversity of competitors with different strategies, sizes and areas of focus.

APRA has referenced *'strong competition in the housing market'* as one of the key reasons for announcing further steps to reinforce sound residential mortgage lending practices.[20] The Governor of the RBA has also recently stated: *'…if you are worried about competition in lending, I do not think it is worth spending any more time, frankly, on mortgages – there is plenty of competition there.'* [21]

The Inquiry noted the policy objectives of *'competitive neutrality'* and the *'long-term competition benefits of assisting to maintain a diversity of ADIs into the future'*[22] in coming to the view IRB risk weights should be increased. Diversity is a key feature of Australia's banking system and it is critical that this structure continues into the future.

However, there is no clear evidence that this diversity is in jeopardy, nor did the Inquiry conclude this is the case. Financial service provider diversity is increasing quickly in the financial system with the emergence of new funding models such as peer-to-peer lending and crowdsourcing.

Moreover, increasing IRB risk weights involves increasing the costs of some market participants relative to others. As competition is intended to deliver greater efficiency, Australian consumers would not benefit from this approach. Rather than focusing on differential treatment between market participants, competition should focus on enabling a thriving open market-based system, where customer choice and the operation of standard economic factors determine outcomes, complemented by a well-functioning regulatory and supervisory system.

The mortgage risk weight 'gap' should be clarified

Any assessment of risk weight relativities and any changes to risk weight requirements should start from a 'like for like' base. The issue can then be assessed based on what, in fact, the risk weight differential is.

In Westpac's view, the Final Report overstates the difference between average risk weights for Advanced IRB and Standardised banks. It notes that the current average IRB and Standardised mortgage risk weights is *'18 per cent and 39 per cent respectively.'*[23] However, there are a number of offsetting factors not included in these figures.

Standardised banks benefit from concessions not available to IRB banks, including lower weight of undrawn limits and no requirement for expected loss capital deductions. A typical mortgage portfolio has drawn balances that are 16% below current limits, giving a 3% risk weight benefit to the Standardised rules. The expected loss deductions (applied to IRB banks) add 1% to IRB risk weights, which increases the effective concessions for Standardised risk weights to 4%. These effects reduce the average Standardised mortgage risk weight to 35%, rather than the 39% stated in the Final Report.

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[20] APRA Media Release, *Further steps to reinforce sound residential mortgage lending practices,* 9 December 2014.
[21] p. 10, Hansard, House of Representatives Standing Committee on Economics, Reserve Bank of Australia Annual Report 2014, 13 February 2015.
[22] p. 65, FSI Final Report, November 2014.
[23] Ibid.

IRB banks are also subject to capital requirements not applied to Standardised banks, including for interest rate risk in the banking book. IRB banks must maintain continuing investment in risk modelling capabilities, and the four major banks will be subject to higher capital ratios to reflect systemic importance through the D-SIB capital charge.

An inherent driver of the systemic importance of the major banks is the size of their residential mortgage portfolios and the interconnectedness of this portfolio with the wider financial system and economy. Applying the 1% D-SIB capital charge entirely to residential mortgage portfolios would effectively result in the equivalent average IRB risk weights being 27% instead of the 18% stated in the Final Report.[24] Applying only half the D-SIB capital charge to residential mortgage portfolios would result in the equivalent average IRB risk weights being 23% instead of 18%.

Taking account of the factors above, the mortgage risk weights 'difference' between IRB and Standardised approaches in Australia is 23-27% for Advanced IRB banks and 35% for Standardised banks.

Clarifying the average mortgage risk weight difference is important, because the Inquiry's recommended increase to IRB mortgage risk weights is based on what it found to be the current difference between the two approaches:

'The Inquiry considers a range between 25 and 30 per cent to appropriate, to be decided on by APRA in targeting an average IRB mortgage risk weight. This is based on international experience and the current average IRB and standardised mortgage risk weights of 18 per cent and 39 per cent respectively.'[25]

Risk weights in a resilience and confidence context

As outlined above, the BCBS proposals are likely to lead to changes in the way Australian banks calculate capital requirements and, particularly through the introduction of a floor for IRB banks based on the Standardised approach, to reduce the mortgage risk weight 'difference' between IRB and Standardised banks.

The proposed changes are based on global rather than domestic concerns and are unrelated to the risk characteristics of the Australian market. Therefore, it is critical that the BCBS changes are implemented in Australia in a way that appropriately reflects domestic circumstances.

An efficient risk-based approach to capital measurement and allocation should be preserved, and the conservative nature of Australia's mortgage capital requirements, as well as the strong features of the Australian mortgage market, should be recognised.

To support these objectives, the following principles should be applied:

[24] Based on Westpac December 2014 Pillar 3 data, attributing the additional D-SIB capital charge to the mortgage portfolio effectively increases risk weights by 9 percentage points. The same impact has been assumed across all Australian IRB banks.
[25] p. 65, FSI Final Report, November 2014.

- Risk-based measures of capital should continue to be available to institutions that have the capability to accurately assess risk;
- Valid differences in the risk characteristics of different jurisdictions should be a legitimate basis for some variation in risk weights globally. This is a particularly important principle for Australia, given the strong risk management and market features associated with mortgage lending in our market. Should valid risk and structural differences not be recognised in the new requirements, strongly capitalised and lower-risk jurisdictions such as Australia will be relatively disadvantaged in being required to hold much higher regulatory capital than is commensurate to their risk;
- Greater risk-sensitivity in the Standardised approach relies on the selection of predictive risk drivers. For example, early prepayment is a strong predictor of low risk of default and is more consistently predictive than the proposed measure of debt serviceability cover;
- For the Australian market, the important risk management role of Lenders Mortgage Insurance should be recognised; and
- While a capital floor 'connecting' the Advanced and Standardised approaches may be appropriate, the design of the floor should be principles-based rather than based on a subjective percentage of the Standardised average. The design and calibration of the floor should allow IRB modelling to appropriately reflect differences in risk profile due to portfolio diversification, jurisdictional differences and other factors.

It is critical that these principles are reflected in both the global design of the BCBS capital requirements and their domestic implementation. Westpac is actively engaging in the Australian banking industry's input to the BCBS processes and will continue to do so.

Recommendation 3

Loss absorbing and recapitalisation capacity

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

Introduction

Westpac generally supports the Inquiry's recommendation and observations regarding the implementation of a bail-in regime in Australia, particularly that;

- APRA should develop a loss absorbing and recapitalisation framework aligned with international standards; and
- It should not generally seek to move outside international frameworks or ahead of global peers unless there are specific domestic circumstances to warrant this.[26]

Bail-in continues to be an evolving global issue through the Financial Stability Board's (FSB) consultation on an international bail-in framework for Global Systemically Important Banks (G-SIBs). The ultimate mode of implementation of Recommendations 1 and 2 of the Final Report will also influence whether a bail-in framework is appropriate for Australia and, if so, to what extent.

[26] p. 67, FSI Final Report, November 2004.

This is because both recommendations have the capacity to affect the capital requirements of Australian banks and are relevant to the issues of stability and 'too big to fail.' The resolution of this global and domestic agenda should be a prerequisite for any decision on the features of an Australian bail-in framework.

Globally, bail-in regimes are currently only proposed by the FSB for G-SIBs. To ensure that Australian banks can compete for funding with their international peers, any Australian bail-in regime should only be put in place if D-SIBs globally are required to adopt bail-in, and on the same timetable.

Principles of an Australian bail-in framework

Any domestic implementation of bail-in should be carefully designed for local circumstances. The industry should work closely with regulators to develop a system that serves to minimise systemic risk and will mitigate the prospect of taxpayer support during a crisis, while not unnecessarily hindering the economy during normal economic conditions.

Westpac believes a number of principles should be considered for the implementation of a bail-in regime in Australia:

- A contractual bail-in regime should be preferred to a statutory-only approach. Given issues with the enforcement of a statutory-only regime on foreign law governed instruments (for example bonds issued in the U.S. or Europe), the instruments need to contain a provision that binds the lender and investor to the bail-in mechanism. This will allow most of the bail-in mechanism to be enacted in domestic statute so that Australian bail-in bonds do not appear to investors to be inferior to bail-in bonds issued by non-Australian banks;
- Existing debt will need to be grandfathered with sufficient time given for banks to meet any bail-in minimum requirements through new issuance in the ordinary course. A staggered implementation requirement should be considered to meet this objective;
- Preserving the ability to issue senior debt that would not be subject to bail-in is critical. This should partially offset both the potentially greater cost of issuing senior debt that is subject to bail-in and the smaller volume that issuance of such bail-in bonds is likely to achieve;
- A compelling argument should be presented for any bank to be excluded from a bail-in regime, although it may be appropriate for there to be differing requirements depending on the size and business models of individual banks;
- All deposits that are also 'protected accounts' under the *Banking Act 1959* should be excluded from a bail-in regime due to the statutory priority those deposits enjoy upon the winding up of a bank. There should be future consideration of whether deposits that are not protected accounts should be subject to bail-in;
- The Inquiry's suggestion that bail-in instruments should be a Tier 3 layer could be appropriate, provided it is also how bail-in is instituted in most offshore jurisdictions;
- The framework should take into account Australia's conservative implementation of Basel III and adjust the Total Loss Absorbing Capacity framework accordingly;
- Potential credit rating impacts should be taken into account and consultation with ratings agencies will be needed. This should be considered when determining the length of any consultation period; and

- The domestic bail-in framework should not favour one corporate structure over another. For example, ADIs with non-operating holding company structures should not be in a better or worse position for bail-in than operating company ADIs.

Recommendation 4

Transparent reporting

Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework.

Westpac supports the objective of greater international comparability in bank capital ratios.

However, there is little merit in a template that reports Australian bank capital ratios against the minimum Basel capital framework. Unless this approach was replicated by a broad number of banks globally, it would not provide investors with any additional information through which to compare Australian bank capital ratios with banks around the world.

Moreover, only part of APRA's conservative application of capital requirements would be normalised, therefore showing a misleadingly weaker position for Australian banks. This is inconsistent with the Inquiry's policy objective of *'reducing disadvantages that may arise for Australian ADIs due to difficulties in comparing Australian ADI capital ratios to international peers.'*[27]

There is merit in focusing on an internationally harmonised reporting template for Australian banks, which would assist investors in comparability of capital ratios. This work should be completed once the evolution of the global regulatory agenda on capital requirements, and its application to Australia, is better understood.

Recommendation 5

Crisis management toolkit

Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry.

Westpac supports this recommendation.

Appropriate crisis management powers promote a resilient financial system and enable the orderly resolution of distressed financial institutions.

Westpac also endorses the Inquiry's observations that:

- Pursuing industry-wide structural reforms such as ring-fencing is not recommended; and
- All proposals should go through the appropriate consultation, regulatory assessment and compliance cost assessment processes.[28]

[27] p. 76, FSI Final Report, November 2014.
[28] Ibid at p. 81.

On resumption of these consultation processes, Westpac will work closely with regulators in developing a regulatory and legislative 'toolbox,' which will work most efficiently in the Australian context to ensure our framework has the capacity and capability to manage a crisis situation with minimal systemic disruption.

This work should also reflect international regulatory developments relating to bank resolution and addressing the issue of 'too big to fail.'

Recommendation 6

Financial Claims Scheme

Maintain the ex post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions

Westpac supports this recommendation.

No compelling case has been made to move to an ex-ante model, a change which would involve an ongoing cost for all Australian ADIs and, absent risk-based pricing, raise the risk of moral hazard in the banking system.

As outlined in Westpac's Second Submission to the Inquiry, a number of features demonstrate that the Financial Claims Scheme (FCS) ex-post funding structure adequately protects deposits in Australia:

- Due to high loan to deposit ratios in Australia, local depositors are well covered by high quality assets. Therefore, in the event of a bank failure, is it likely that wholesale debt financiers will be most at risk of loss; and
- Australia's deposit preference regime also protects depositors in the event of bank failure.

The ex-post funding structure of the FCS should therefore be retained.

Recommendation 7

Leverage ratio

Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions' risk-weighted capital positions.

Westpac supports this recommendation, in particular the introduction of the leverage ratio as a backstop to ADIs' risk weighted capital positions rather than as a binding constraint. However, the leverage ratio should not override the risk-based approach to capital as the primary measure of capitalisation.

The leverage ratio backstop function is consistent with how leverage ratios were framed, stated and intended under Basel III. Leverage ratios are not intended as a replacement to the risk-based approach to capital. Rather, they serve an important purpose for limiting systemic risk and maintaining investor confidence in the strength of institutions.

Westpac endorses the Inquiry's view that *'having a leverage ratio as a meaningful backstop provides appropriate insurance against the risks inherent in risk-based capital requirements, while retaining the advantages of having capital requirements commensurate with risk.'*[29]

Such an approach appropriately increases financial system resilience, while retaining the benefits of a risk-based approach to capital allocation. The application of any leverage ratio in Australia should recognise APRA's conservative approach to capital interpretation.

Recommendation 8

Direct borrowing by superannuation funds

Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds

Westpac agrees with the Final Report's observation that a largely unleveraged superannuation system provided a stabilising influence on the broader financial system and economy during the GFC.[30]

The current level of superannuation fund borrowing is small. Borrowing by self-managed superannuation funds (SMSFs) remains only approximately 1% of the Group's mortgage balances. Further, Westpac SMSF lending is managed by specialist bankers to ensure that loans are correctly structured, and that customers have been given appropriate guidance before entering into a loan. Credit policy and processes for SMSFs are also more conservative than standard mortgages, including lower LVR limits, different LVR tiers according to the structure of the SMSF, appropriate financial advice warnings recommending that SMSF trustees consider obtaining independent financial advice before entering into a loan, and personal guarantees.

Westpac acknowledges that there are systemic benefits to a large, unleveraged savings pool and that the primary objective of the superannuation system is as a savings vehicle for retirement.

If Recommendation 8 is implemented, Westpac supports the Inquiry's observation that it should operate prospectively and permit funds with existing borrowing to maintain those borrowings.

[29] p. 85, FSI Final Report, November 2014.
[30] Ibid at p.87.

Chapter 2 – Superannuation and retirement incomes

Recommendation 9

Objectives of the superannuation system

Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the longer term.

Westpac supports this recommendation. The core guiding principles and legislative structure through which this broad political agreement is achieved should be determined after a period of public consultation and through the work of a joint parliamentary committee.

A clear, bi-partisan articulation of the objectives of the superannuation system is critical for providing an evaluation framework for the effectiveness of the system, and to support long-term confidence and policy stability.

Westpac supports the Inquiry's recommended objective for superannuation, being to *'provide income in retirement to substitute or supplement the Age Pension,'* and that the objective is enshrined into legislation. A framework should be developed to dimension or phase the level of retirement income and its duration. Wide-ranging consultation on the elements of this framework is critical. Potential elements of this framework could include:

- A target income replacement rate of 65-70% for all Australians, up to an agreed multiple of Australia's average weekly earnings. This would support the most efficient allocation of tax concessions for superannuation and Age Pension support;
- An example of a phased approach to retirement income could be:
  - Phase 1 to focus on the delivery of a flexible income stream of 65-70% (with access to capital) from retirement age up to mean mortality age (the 'active stage'); and
  - Phase 2 to focus on a stable or guaranteed income above mean mortality age (the 'frail stage') to protect against longevity risk; the income stream having been pre-purchased at the point of retirement where the cost is cheaper and risks can be pooled.
- To effectively address the issue of Australia's ageing population and longevity risk in superannuation, consideration should be given to defining the age of eligible access to the Age Pension and superannuation based on a percentage of Australia's mean mortality age.

A framework for defining a target income replacement rate would help determine policy settings. This would have the benefit of:

- Driving an asset allocation by super funds to meet the retirement income objective;
- Highlighting to members the importance of voluntary contributions;
- Evaluating the need and value of superannuation tax concessions; and
- Ultimately being able to assess the success of the system.

In defining the level of adequate retirement income, a Senate Committee in 2002 found that retirees needed to replace 65% of their pre-retirement income to live comfortably.[31] This supports the original intention that superannuation should aim to replace 70% of an individual's pre-retirement income.

All of the superannuation system's settings should reinforce the objective of the system. The tax treatment relating to superannuation is a key part of these settings. Westpac endorses the Inquiry's observation that the Tax White Paper considers the objectives of the superannuation system when evaluating superannuation tax policy proposals.

Recommendation 10

Improving efficiency during accumulation

Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.

Westpac believes that the combination of both the Stronger Super reforms and the introduction of an open competitive MySuper market will deliver substantial efficiency benefits during the accumulation phase of superannuation. Westpac supports a review into the performance of the MySuper reforms in 2020 to demonstrate they have achieved their objectives.

Evidence already shows that the implementation of MySuper has reduced fees in the default market. For example, there has been a significant reduction in 'retail' sector average asset-based MySuper fees – from 1.61% for pre-MySuper default products in 2011, to 0.82% by 2013.[32] Research by RiceWarner, commissioned by the Financial Services Council (FSC), confirmed this preliminary data by concluding that fees have fallen significantly amongst the membership of the FSC since the inception of MySuper.[33]

While evidence has already emerged that default superannuation fees have started to decrease due to the MySuper reforms, Westpac believes that only by allowing employers to select any MySuper product will competition substantially increase and drive better consumer outcomes over the medium term.

The current Modern Award arrangement limits the number of market participants from competing for business and therefore reduces superior performance and pricing that could otherwise benefit individual superannuation members.

Westpac believes allowing employers to select a default superannuation fund will bring an important level of additional competition lacking from the superannuation market place.

The MySuper reforms have ensured that all default superannuation funds must meet minimum standards, considerably higher than previously, as well as being more easily comparable through standardised fees and APRA MySuper reporting.

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[31] 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.
[32] p. 10, Financial Services Council, FSI Submission, September 2014.
[33] Ibid.

Should Government consider that an additional filter is necessary to support an open competitive MySuper market, a further 'subset' of MySuper funds, determined by APRA, could be identified for the purpose of employer selection. APRA could select these funds based on clear criteria such as performance, governance, experience and scalability.

The proposed review of Stronger Super should not take place until 2020. This timeframe ensures the entire superannuation industry has fully implemented both MySuper and SuperStream (by mid-2017) and the industry has had a reasonable period of time to openly compete and, if necessary, consolidate.

While Westpac is confident a move to an alternate default super distribution model, post 2020, will prove to be unnecessary, we do not support the proposed introduction of an auction or tender process for default fund allocation.

A national auction or open tender approach (a 'Chilean Model') would require an unprecedented level of government central planning, and force funds to focus disproportionately on the price aspects of their offering rather than ensuring the best retirement outcome for their members. Furthermore, there is no compelling evidence that a Chilean Model would produce the stated objective of lower fees. For example, research by Chant West shows the average total MySuper fee of 0.85% was lower than the Chilean default fee of 0.92%.[34]

Recommendation 11

The retirement phase of superannuation

Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.

Westpac strongly supports a greater focus on providing adequate retirement incomes for all Australians, and endorses the pre-selection of a comprehensive income product for members' retirement recommended by the Inquiry.

The development of guiding principles for this new approach will require significant consultation between Government and industry, and Westpac aims to be actively involved in this process.

It is also important to recognise that the needs of individual retirees differ. Therefore, the Inquiry's recommended comprehensive income product should be principles-based and supported by an integrated advice model which provides targeted, simple advice to members to ensure that the pre-selected product is properly calibrated.

[34] p. 22, Financial Services Council, FSI Submission, September 2014.

Recommendation 12

Choice of fund

Provide all employees with the ability to choose the fund into which their Superannuation Guarantees are paid.

Westpac supports this recommendation. All Australians should have the ability to make their own decision on how, and with which superannuation fund, they choose to invest their retirement savings.

Recommendation 13

Governance of superannuation funds

Mandate a majority of independent directors on the board of corporate trustees on public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements

Westpac supports this recommendation.

Consistency across APRA-regulated financial services providers simplifies the regulatory framework and eliminates unnecessary variation in governance models across the financial services industry. Given the significant responsibility of managing Australia's wealth savings, governance standards of public offer superannuation funds should generally meet the standards required of listed companies.

The proposed changes to board composition requirements, the director penalty regime and conflict of interest requirements improve this consistency and promote confidence that superannuation funds are governed to the highest standards. Confidence is a key driver of the effectiveness of the superannuation system.

Appropriate transitional arrangements should be implemented to allow entities to meet any new obligations.

Chapter 3 – Innovation

Recommendation 14

Collaboration to enable innovation

Establish a permanent public-private sector collaborative committee, the 'Innovation Collaboration,' to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.

Westpac supports the establishment of the Innovation Collaboration for facilitating interactions between financial sector innovators, Government and regulatory agencies in a single coordinated forum.

Digitisation and related innovation will fundamentally change the financial services sector and blur the borders between industries, related economics and business models. In an increasingly complex and fast moving digital economy, characterised by industry convergence and new market participants, innovation will drive improved customer experience but can also lead to unpredictable outcomes for both financial services and for the end to end value chain.

To most effectively enable timely policy and regulatory responses to these changes, Westpac sees a benefit for more focussed and shorter cycle communication on innovation and its related themes of security, privacy, competition and ensuring ongoing stability and trust in the financial system.

Recommendation 15

Digital identity

Develop a national strategy for a federated-style model of trusted digital identities.

Westpac supports this recommendation, which would provide significant benefits to consumers, businesses and government.

The financial industry's stability is founded on trust, and Westpac believes that one of its fundamental roles is as a centre of trust for the community. A key building block of trust is protecting identity and allowing digital interaction to occur with a commensurate level of guaranteed 'execution' from all sides.

The development of a federated-style model is complex, involving many economy-wide stakeholders and considerations regarding security of information, privacy, potential legislative change and cost allocation. A paramount consideration will be to ensure that high levels of customer information security are maintained and that any community concerns regarding a national strategy are appropriately addressed.

Clarity of the model design, particularly the revenue, liability and privacy framework, is therefore critical to the successful development of the trusted digital identity strategy.

Recommendation 16

Clearer graduated payments regulation

Enhance graduation of retail payments regulation by clarifying thresholds for regulation by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority.

Strengthen consumer protection by mandating the ePayments Code. Introduce a separate prudential regime with two tiers for purchased payment facilities.

The current structure of retail payments regulation has facilitated resilience, efficiency and competition in the payments system. Any changes to the regulatory framework must have clear, demonstrable benefits.

To enhance graduation of retail payments regulation and strengthen consumer protection:

- Regulators should publish a clear guide to the framework for industry, and in particular for new entrants, that outlines thresholds and regulatory requirements;
- Consumer protection regulation for retail payment service providers should be simplified and improved through extending basic consumer protection regulation under the current voluntary ePayments Code to all service providers; and
- Regulators should review the extent to which their current powers enable them to regulate system and service providers using alternative mediums of exchange to national currencies, such as digital currencies.

Recommendation 17

Interchange fees and customer surcharging

Improve interchange fee regulation by clarifying thresholds for when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees.

Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.

Westpac does not agree with the Inquiry's conclusion that interchange fee regulation would be improved by broadening the range of fees and payments to which current thresholds apply and by lowering interchange fees. The stated benefits of this approach are unproven and could have unintended consequences for innovation and customer choice in the payments system.

Westpac believes further progress of key industry initiatives will increase competitive pressure among payments network fees and support positive customer outcomes. The focus should be on less regulatory intervention in interchange fees, rather than more.

On 4 March 2015, the Payments System Board (PSB) released an Issues Paper to commence a review of the regulatory framework for card payments. Westpac will actively contribute to the PSB's Issues Paper process.

Westpac's observations regarding the Inquiry's recommendation, which are equally applicable to the Issues Paper, are discussed below.

Interchange fees

Australia's payments system is largely operating effectively. Recent years have seen accelerating innovation in the system through new entrants and increasingly robust competition between schemes and systems. The payments system:

- Is overseen by a strong regulator in the PSB with a demonstrated record of garnering industry support and financial engagement;
- Has experienced a long period of stability, with continued consumer confidence in the safety of the system;
- Features a strong degree of co-regulation, for example through the activities of the Australian Payments Clearing Association (APCA);
- Has a track-record and future roadmap of innovation through initiatives such as the New Payments Platform (NPP), which involve significant investment expenditure commitments from the banking industry; and
- Has a strong degree of competition among existing and new entrants, and a diverse industry structure engendered by new, disruptive technologies. Evidence of this diversity is that APCA's membership consists of almost 100 market participants. New entrants are expected to continue to grow in the future as the pace of technological innovation accelerates.

Significant changes to this regulatory and industry framework should therefore be predicated on compelling benefits.

While the Inquiry's stated objective is to *'improve the transparency and efficiency of interchange fee regulation,'*[35] the connection between improved interchange fee regulation and lower interchange fees (and lower customer prices) is not proven. There is mixed academic support of this linkage, as for example noted by the academic papers considered at the PSB Payments System Reforms Review conference which in 2007 considered these issues.[36]

Rather than focusing on further regulation, increased competition in the payments system brings into question the very need for interchange fee regulation. In its most recent review of interchange fees,[37] the PSB concluded that its preferred option was to remove interchange fee regulation. This view was subject to certain industry prerequisites, primarily the formation of EFTPOS Payments Australia Limited (EPAL) and an alternative system for online payments. By 2009, the PSB believed those industry pre-requisites had still not yet been met but noted their relationship to greater competition:

[35] p. 168, FSI Final Report, November 2014.

[36] pp. 5-26, *Payments Review Conference,* http://www.rba.gov.au/payments-system/resources/publications/payments-au/paymts-sys-rev-conf/2007/psr-conf-vol-2007.pdf

[37] 2007/2008 PSB Review of Card Payment Systems Reform.

"While the Board noted the establishment of EFTPOS Payments Australia and the renewed commitment to develop an online payments system (the MAMBO project), it does not believe that these initiatives have yet reached the point where they will exert significant competitive pressure on interchange fees, though such a position may well be reached over time."[38]

Currently, EPAL has further progressed its functionality and the NPP work is progressing soundly. There is, therefore, a likely pathway for increased competition among payments networks. Allowing these features of the current system to continue to develop is a less disruptive approach than pursuing further regulatory change, and one that is likely to support positive customer outcomes in the future.

Further, as noted by the Inquiry,[39] the removal of interchange fee caps has a number of economic benefits compared with the other options considered by the Inquiry:

- Increased competitive neutrality for system providers;
- A significant increase in simplicity and clarity of regulation; and
- Decreased compliance and transitional costs compared with other regulatory-based options.

Greater interchange fee regulation could also have a number of unintended consequences. While the Inquiry concluded that the current interchange structure leads to cross-subsidies, this is a common feature of markets that leads to the innovation of products that otherwise may be uneconomical. Interchange fees address a market failure, by internalising externalities created between cardholder and merchant.[40] Reduced interchange fees are likely to reduce the financial incentive for innovation in the market. This could adversely impact customer choice through, for example, reduction in the availability of products such as credit cards linked to third party loyalty schemes. As the effective use of credit, including rewards, can bring forward consumer spending and economic stimulus, a reduction in the availability of these products could have negative macroeconomic effects.

Broadening the range of fees and payments to which interchange regulation applies could also involve significant, costly overhaul or replacement of current merchant acquiring systems. This would involve further investment, in excess of current commitments to contactless technology and the NPP. Even if interchange fees were to decrease with a regulatory solution, end-costs to merchants may remain largely unchanged.

In reviewing increased competitive pressures between network operators and improved customer outcomes, a key area for investigation should be the completion of the work commenced by the PSB in its 2007/2008 review, which stated a preference for assessing what would be required for the removal of interchange fee caps.

Customer surcharging

Recent RBA analysis suggests that, for the most part, merchant services fees are generally (but not always) in line with card acceptance costs:

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[38] http://www.rba.gov.au/media-releases/2009/mr-09-18.html

[39] p. 174, FSI Final Report, November 2014

[40] p.145, Jean Tirole (awarded the 2014 Nobel Peace Prize for Economic Science), *Payment Card Regulation and the Use of Economic Analysis in Antitrust,* Competition Policy International, 2011.

'The median level of a surcharge paid by respondents was 1.8 per cent, with the median on payments using American Express and Diners Club cards (2.0 per cent) higher than that on MasterCard and Visa cards (1.5 per cent). Based on other information about the range of merchant service fees, surcharges up to around these levels would not obviously be at odds with the card acceptance costs of many merchants.'[41]

Nevertheless, it must be acknowledged that there is significant customer concern regarding excessive surcharging and this has the potential to significantly erode confidence in the payments system.

Improvements in surcharging should focus on circumstances of demonstrable overcharging. For example, the Victorian Government has recently legislated that taxi surcharging be limited to 5%. This type of regulatory enforcement approach directed at individual circumstances, rather than a complex set of new prescriptive regulations that would apply to the entire market, is the appropriate policy response to cases of overcharging in the market.

Recommendation 18

Crowdfunding

Graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.

Access to both debt and equity financing is important for business in Australia, particularly start-up businesses. Australia has an underdeveloped market for equity financing, especially venture capital. Westpac considers that additional equity funding sources, including crowdfunding and peer to peer lending, are viable forms of financing for many small businesses and should be encouraged. This should be facilitated under an appropriate regulatory regime to balance enhanced access to finance and investor protection.

Recommendation 19

Data access and use

Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about privacy protections.

Westpac supports the recommended review on the basis that the principles guiding the access and use of data need further clarification.

There is significant potential damage to trust in the financial services sector created by the misuse of information and by more open data usage. Westpac strongly believes that, in balancing the interests between protection of privacy (and the conjoined issue of preservation of trust in the banking sector) and sharing information to increase competition (raising the risks from data 'misuse' from both incumbent participants and – often unregulated – new participants), privacy and trust concerns should be paramount.

[41] pp. 38-39, The Changing Way We Pay: Trends in Customer Payments, RBA, http://www.rba.gov.au/publications/rdp/2014/pdf/rdp2014-05.pdf

Industry-wide requirements for increased data access and use would likely require regulatory change. In particular, introducing rules for the delivery methods, timelines and standards for providing data in response to access requests would require amendment to the Privacy Act or regulations for those rules to have legal force.

Prescribed rules for the delivery methods, timelines and standards for providing data in response to access requests would introduce significant costs for the industry. Since personal information is held across many different providers and technology systems, there would be significant challenges with applying consistent rules for the presentation and delivery of information.

Recommendation 20

Comprehensive credit reporting

Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime. If, over time, participation is inadequate, Government should consider legislating mandatory participation.

Westpac believes that natural competitive forces, rather than mandating, should shape comprehensive credit reporting (CCR) in Australia. Westpac acknowledges the Inquiry's recommendation that, in 2017, Government should review industry's participation in CCR to determine whether a regulatory incentive or legislation for mandatory reporting is required.

Mandatory CCR would impose additional costs to industry compared with the current model. For example, lenders under a mandatory approach would be required to provide all credit data for all portfolios by a specified date. This would remove the opportunity to evaluate areas of greatest benefit and to drive efficient investment in those portfolios where CCR will drive most improved decision making. For example, mandatory investment in aged portfolios that are largely inactive may involve significant additional infrastructure investment for no clear advantage to consumers. In contrast, a voluntary approach allows lenders to direct investment where most benefit will be realised.

A mandatory approach could also lead to the development of inefficiencies in the market for the supply of comprehensive credit reporting services, as 'early-mover' suppliers are able to access the full suite of mandatory information from credit providers.

Many businesses are developing alternative means of gathering information to better understand customer preference and other characteristics relevant to credit decisions. This includes the use of social media, big data and other analytics. New lending models such as peer to peer lending will also be relevant to the credit data sharing market. A mandatory approach may be superseded by these developments in a relatively short time period.

The Final Report notes its support for expanding the number of CCR data fields, for the purpose of providing high-quality credit data that would lead to improved credit decisions for borrowers. A focus for examining the appropriateness of expansion of CCR data fields should be the inclusion of customer balances in CCR, for example, the amount a customer has repaid on their mortgage or the undrawn limit on a credit card.

While positive reporting currently includes information on customer limits, the effectiveness of this information in improved credit decisions is limited without customer balances. This information is important to a lender’s knowledge of a borrower’s credit position.

Westpac therefore supports further review of the data-fields to be included in CCR.

Chapter 4 – Consumer outcomes

Recommendations 21 and 22

Strengthen product issuer and distributor accountability

Introduce a targeted and principles-based product design and distribution obligation

Introduce product intervention power

Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is a risk of significant consumer detriment.

Introduction

Building confidence and trust in the financial system should be a continuing priority for the system's institutions, regulators and policy makers. The financial system relies on trust to effectively discharge its function of supporting the growth of the economy and supporting customers in achieving their financial goals.

Westpac fully supports the Inquiry's focus on strengthening the accountability of product issuers and distributors. The 'end-to-end' process of designing, manufacturing and distributing products and services should focus on doing the right thing for customers throughout the life of the relevant product or service. Product issuers and distributors should ensure that their products and services are designed to meet customers' needs and perform as promised, and customers should be provided with the information they need to make informed decisions.

Currently, a number of legal and regulatory mechanisms in Australia's consumer protection framework require this accountability. In turn, many product issuers and distributors reflect these requirements through their policies and governance arrangements for product design and distribution. In many cases, the operation of current legal and regulatory mechanisms can be complex for financial firms and customers.

Implementation of the principle-based obligation in Recommendation 21 should be undertaken with clarity and simplicity, and presents an opportunity to help streamline the operation of existing product design and distribution obligations.

Clear and consistent legal and regulatory obligations will protect consumers and give product issuers and distributors a strong framework in which to innovate and provide wide-ranging choice for customers, including as customers' needs and preferences change. A more streamlined framework will also best support ASIC's regulatory activities.

Westpac supports ASIC having a clear mandate, strong powers, and appropriate resourcing to effectively address consumer protection issues. ASIC currently has a wide range of powers to meet this objective. However, the resourcing and funding of ASIC to most effectively use its powers should be improved to support the regulator's ability to execute its mandate.

The Inquiry has proposed a further ASIC intervention power in Recommendation 22. There is an opportunity to design this power with clear accountabilities and a targeted scope, focused on those areas where ASIC's current powers are shown to be clearly inadequate.

Westpac's detailed responses to these recommendations are discussed below.

Recommendation 21

Strengthen product issuer and distributor accountability

Introduce a targeted and principles-based product design and distribution obligation

The Inquiry is proposing a new targeted and principles-based product design and distribution obligation be enacted into law, that would apply universally, although be scalable for the nature of the product and services.

Westpac strongly supports the need for a clear and consistent product design and distribution obligation. Government's response to the Inquiry presents an opportunity for clarity on which legal and regulatory standards should apply to various types of products and services and a robust, consistent approach to implementation across banking and wealth sectors.

Current consumer protection framework

A focus of the Inquiry's analysis for proposing a new obligation is product suitability and to:

- Reduce the number of consumers buying products that do not match their needs, and reduce consequent consumer detriment;
- Promote fair treatment of consumers by firms that design and distribute financial products;
- Promote efficiency and limit or avoid the need for more prescriptive regulation; and
- Build confidence and trust in the financial system.

Westpac supports these objectives, and they are currently reflected in a range of legal and regulatory mechanisms, including:

- Requiring credit providers and credit intermediaries to determine that a credit product 'is not unsuitable' for the consumer under the *National Consumer Credit Protection Act 2009*. The Inquiry acknowledged that these products should not be subject to the new legal obligation;
- Legal duties to clients including, for example, 'best interests' tests on financial advisers and superannuation trustees;
- A range of requirements in the *Corporations Act 2001*, including retail and wholesale investor tests;
- The general prohibitions on misleading and deceptive conduct;
- The requirement that financial products are fit for purpose; and
- Active conduct and prudential supervision, which often imposes obligations at the Board level.

The principle of product suitability is also currently captured in contexts where no specific assessment of financial positions and needs is legally required.

For example, in the wealth space, Product Disclosure Statements for managed investment schemes and superannuation funds generally include sections on the recommended investment timeframe, and an indication of whether the product targets growth or income (or a combination of both) in its investment objective. Furthermore, these funds are issued with standard risk measure classification based on industry guidance.[42]

Many financial providers, including Westpac, also have in place policies and procedures for considering a range of non-commercial customer factors in the development and ongoing management of their products and services. These internal frameworks are a reflection of current legal and regulatory arrangements, and demonstrate the reach of the existing framework in supporting accountability. This kind of accountability is now widely seen as valuable to ensure provider and customer interests are aligned, and that the business practices of financial providers are sustainable and in line with community expectations.

The current system therefore involves various legal, regulatory and other elements that require product issuers and distributors to actively consider the suitability of products to customers. A new principles-based obligation presents the opportunity to help streamline this framework.

Clarity of implementation and avoiding unintended consequences

Without clear and simple implementation, the proposed obligation in Recommendation 21 will expand the existing regulatory framework. It could potentially overlap with existing regimes and obligations concerning product design, manufacture, disclosure and distribution. Complexity in this area has the potential to drive layers of process, as compliance regimes are built to provide evidence-based systems for each specific legal or regulatory requirement. Fewer, clearer and complementary requirements will help ensure stronger, simpler processes and controls that benefit customers.

Careful consideration is therefore needed in how the obligation would work with the existing framework. For example, Westpac believes an additional product suitability obligation should not apply to personal advice, where product suitability is more appropriately addressed through the existing personal advice obligations which include the statutory best interest obligation, duty of priority and general law obligations. Other existing applications of principles-based regulation may also need to be repealed or revised to ensure consistency and clarity with the proposed obligation.

Implementation of the proposed obligation should also recognise that the capacity of product issuers or distributors to determine whether a product is suitable can often be context specific. While a product may generally be designed to cater for customers with a high-risk appetite, it is possible that customers with a balanced portfolio may still appropriately invest in that product as a small percentage of their overall portfolio. Only a personal adviser who is considering a client's personal circumstances is in a position to understand whether such a product is appropriate in the client's circumstances.

[42] Provided by the Financial Services Council and/or the Superannuation Funds of Australia.

There is also a risk that the burden of compliance becomes prohibitive for market participants or, at a minimum, represents a significant barrier to entry for new or smaller market participants. Product issuers could be incentivised to design and distribute products in the most generic way, regardless of the product concerned or the sophistication and preference of customers, to minimise their own risk. Some firms may exit a market completely.

This experience has been evident in recent times in the United Kingdom (UK), which has undergone significant changes to its regulatory consumer protection framework. An example of this change is the Retail Distribution Review (RDR), conducted by the UK Financial Conduct Authority. The RDR was aimed at identifying and addressing the root causes of problems emerging in the UK retail investment market including products and services offered by retail banks, life insurers, financial advisers, building societies, stockbrokers and fund managers.

Since the RDR, most major financial institutions in the UK have significantly withdrawn from the advice market. Research by Cass Business School, City University London, has identified that an investor who has less than £61,000 ($110,000) to invest is no longer commercially viable to service. Research suggests that 75% of the UK's adult population does not have current investible assets above this level.[43] This example demonstrates the importance of considering unintended consequences, such as to financial access, in any significant new regulatory intervention.

It is also critical that a clear, robust, consistent standard is developed that enables firms' targeted compliance investment to meet the requirements of the new obligation, within an overall sustainable compliance approach. The existence of multiple regimes of legislative and regulatory standards can lead to highly inefficient compliance investment. Firms are able to implement stronger compliance systems when designing fewer, clearer requirements, and customers also benefit from this approach as required information can be sought from them once rather than repeatedly in different forms.

Compliance is already a significant share of investment for financial services providers. In the 12 months to 30 September 2014, 32% (or about $340 million) of Westpac Group's total investment expenses related to regulatory change. This has substantially increased from $55 million in the 2005 financial year. Given the size of this investment, clarity and simplicity in the implementation of new legal and regulatory obligations is a key enabler for efficient, sustainable, compliance outcomes.

A consistent and robust implementation process provides an important opportunity to introduce a principles-based design and distribution obligation that effectively protects consumers while enabling product issuers and distributors to innovate with certainty. A simplified consumer protection framework would also assist ASIC in its regulatory enforcement activities.

[43] http://www.cass.city.ac.uk/news-and-events/news/2013/january/fidelity-story-final

Recommendation 22

Introduce product intervention power

Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is a risk of significant consumer detriment.

Westpac believes that ASIC's existing powers, complemented by the Inquiry's important recommendations to improve ASIC's funding model and capacity to execute its mandate, provide a sound base for ASIC to protect consumers and help promote confidence in the financial system.

The scope of the proposed ASIC proactive intervention power should be targeted at areas where ASIC's current powers are clearly inadequate, with objective accountabilities that support certainty for financial firms and customers. This is outlined below.

ASIC's current powers and recent cases of financial loss

ASIC has a wide range of powers to address specific issues of concern under the current law, including powers to make stop orders, powers to take administrative action (including banning orders, varying licence conditions, suspending or cancelling an AFS licence) and powers to issue infringement notices. Through these powers, ASIC has the ability to take wide-ranging steps to ensure that a financial services licensee acts fairly, efficiently and honestly.

The Inquiry substantially based its conclusion that the broad intervention power is needed on the reasoning that *'Australia has had cases of significant consumer detriment where ASIC had exhausted its current regulatory toolkit and where there was no clear basis to take enforcement action.'*[44] The scope of the proposed new power should be referable to specific gaps in ASIC's current regulatory toolkit that these cases demonstrated.

Greater clarity in the scope of the power

The scope of the power recommended by the Inquiry is, in some respects, very wide. There is an opportunity to design a more targeted scope, with clear and objective accountabilities. Specifically:

- The test of *'significant risk of consumer detriment'* proposed by the Inquiry is a subjective threshold. It is intended to operate without an actual or suspected breach of the law, which the Inquiry states would not be a pre-requisite to exercising the power. The subjectivity of this threshold creates significant uncertainty for the scope of the power. A more objective threshold, which is directly referable to suspicion of the breach, or likely breach, of a specific regulatory or legal obligation would provide greater clarity;

[44] p. 207, FSI Final Report, November 2014.

- The categories of products and classes of consumer to which the power can be applied would need to be clarified – if it is proposed that it should relate to all products and all classes of investors then different thresholds will need to apply before the power is exercised by ASIC. The power should not be available for products that are already comprehensively regulated;
- There are no conditions to exercise of the power other than consultation with APRA when its use may affect an APRA-regulated body. Unlike other administrative action by ASIC which (except in limited circumstances) will involve a hearing before a suspension, cancellation or banning occurs, the proposed power does not appear to have a similar safeguard. This raises the question of procedural fairness. To address this issue, Westpac supports:

    - A statutory requirement that ASIC puts the parties on notice of its intention to use the power and, absent exceptional circumstances, the parties are given the opportunity to be heard before the power is exercised; and
    - A requirement that ASIC provide public reasons for the exercise of the power and, in particular, the factors that warrant intervention over existing legal and regulatory arrangements.

Westpac believes ASIC and the industry should work co-operatively to maintain market integrity and appropriate standards of conduct in the financial sector, with interventionist powers a backstop. Ensuring that ASIC has the resourcing and expertise to perform its mandate efficiently and effectively is a key component of this cooperative approach.

This approach should support continued confidence and trust in the Australian financial system, which is essential for supporting customers in achieving their financial goals.

Recommendation 23

Facilitate innovative disclosure

Remove regulatory impediments to innovative product disclosure and communication with customers, and improve the way risk and fees are communicated to consumers.

Westpac fully supports this recommendation, and the important objectives of:

- Promoting more engaging and effective communication with consumers to increase consumer understanding and facilitate better decision making;
- Reducing the number of consumers buying products that do not match their needs; and
- Promoting efficiency, including competition, by better informing consumers.

Westpac has provided detailed comments on these issues to ASIC in response to ASIC Consultation Paper 224: *Facilitating Electronic Delivery of Financial Services Disclosure* and update to Regulatory Guide 221. Key points include:

- The maturing of e-commerce into truly digital banking and financial services is a necessary, transformational part of every financial service company's agenda. The regulatory framework should promote, and not hinder, this transformation;

- More innovative disclosure, including electronic disclosure, is anticipated to bring many benefits to consumers and providers, such as greater scrutiny, customer convenience, faster service delivery, increased customer engagement, reduced paper usage and reduced industry costs;
- Westpac supports legislative amendments and regulatory change to support and encourage industry innovation, technological change and to meet the demands and expectations of consumers; and
- Particular focus areas where Westpac believes current opportunities exist include:

    - The need for technology neutral language to ensure regulation keeps pace with emerging technologies without inadvertently restricting further development (technology neutrality is discussed in further detail in Westpac's response to Recommendation 39);
    - Moving to ensure regulation of online disclosure is consistent across all financial products; and
    - Confirmation that electronic delivery is the default mode of delivery.

Continued consultation with industry and other stakeholders should form an important component of the approach to facilitating more innovative disclosure, given rapid developments in technology.

Recommendation 24 and 25

Align the interests of financial firms and consumers

Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.

Raise the competency of advisers

Raise the competence of financial advice providers and introduce an enhanced register of advisers.

Westpac supports the objectives of Recommendations 24 and 25. There are two key elements of the recommendations which Westpac addresses in this submission:

- The industry raising standards of conduct and levels of professionalism to build confidence and trust in the financial system (including raising the competency of advisers); and
- Government amending the law to provide ASIC with an enhanced power to ban individuals, including officers and those involved in managing financial firms, from managing a financial firm.

Westpac also intends to actively contribute to the Government's consultation on the recommendations of the Parliamentary Joint Committee on Corporations and Financial Services for increasing the professional standards of advisers.

A national professional standards framework for financial advisers

While Recommendation 24 addresses industry standards generally, community concerns and expectations for improved industry standards are focused on financial advice. A common theme is that confidence and trust in financial advice must be improved. Westpac strongly supports this position.

It is important that the number of inquiries and consultation processes, including through the Inquiry, debate regarding the Future of Financial Advice reforms, ASIC consultation papers and inquiries conducted by the Parliamentary Joint Committee on Corporations and Financial Services and the Senate Standing Committee on Economics, do not lead to a fragmented approach to professionalism and education standards across financial advice. The Government's response to the Final Report, and to the recommendations of the Parliamentary Joint Committee on Corporations and Financial Services for increasing the professional standards of advisers, presents an important opportunity to bring together the various processes and review so that a cohesive, overarching approach to improvements in industry standards of advice can be implemented.

The implementation of a new national professional standards framework for financial advisers who provide personal advice to retail clients is an effective way to improve confidence and trust in financial advice. This should be underpinned by the following principles:

- Raising professional standards, including (but not limited to) raising education standards. This requires five key areas of reform:
    - Conduct standards - requiring the adherence to appropriate ethical, behavioural and professional responsibilities. These standards could be defined through a code of conduct, and be overseen by a self-regulatory body that has the ability to instigate and/or refer disciplinary action to ASIC (described below);
    - Formal education standards - following an appropriate transition period for existing advisers of at least five years, Westpac recommends the minimum entry standards to be able to act as a financial adviser should be Australian Qualifications Framework (AQF) level 7 (Bachelor degree);
    - Competence standards - in parallel with raising formal education standards, Continuing Professional Development standards also need to be raised and made part of an ongoing professional certification process;
    - Adviser Leadership standards - these standards would articulate expectations on the way advisers lead and empower clients to achieve their financial goals; and
    - Community standards - a wider focus on community within the professional standards framework is a way in which the industry can build consumer trust and enable financial advisers to truly act in accordance with the meaning of a profession and exercise skills in the interest of others.

- Improving consumer awareness and understanding, through clearer labelling and delineation between financial advisers and other financial information providers – including renaming 'general advice' (see Recommendation 40); and
- This new professional standards framework should be overseen by a new Self-Regulatory Organisation (SRO) that would be funded by the profession and delegated authority under the *Corporations Act 2001* to perform its role. The SRO would be a new body that has a clear mandate to set and govern professional, ethical and education standards for financial advisers. In addition to setting professional standards, the SRO could also be given responsibility for:

    - Acceptance to and removal from the profession;
    - Issuance of practising certificates;
    - Ongoing attestation to meeting professional standards; and
    - Setting of related professional standards for licensees.

This type of model has precedent in other industries both in Australia and abroad. For example, the Law Society of NSW has various functions and powers under the *Legal Profession Act 2004*, including to require solicitors to hold a practicing certificate before they can practice law, to amend, suspend or cancel a practicing certificate and to provide for the law society to develop professional rules for solicitors.

In the US, firms wishing to act as a broker-dealer are required to join a self-regulatory organisation. The Financial Industry Regulatory Authority (FINRA) is the largest of these organisations, and carries out various functions including licencing and accrediting staff at broker-dealer firms, monitoring compliance with US Securities and Exchange Commission (SEC) rules and reporting suspected breaches of rules to the SEC. FINRA is subject to SEC oversight, which can take action against FINRA and other SROs that fail to fulfil their regulatory responsibilities.

Supporting of an enhanced banning power for ASIC

Westpac supports the discrete expansion of ASIC powers to include the ability to ban an individual from managing a financial services business as distinct from providing any financial services (section 920B of the *Corporations Act 2001*). This is consistent with the intent of Recommendation 24 to address 'phoenix-like' activity. Westpac believes that ASIC's other current banning powers, including the circumstances where ASIC may make a banning order, are adequate.

Upfront commissions for life insurance

Westpac has been actively engaged in the Life Insurance and Advice Working Group (Working Group), established to address the issues raised by ASIC's Report 413: Review of retail life insurance advice.

The Working Group's Final Report, released by independent chairman John Trowbridge on 26 March 2015, recommends extensive reform to the life insurance and financial advice sectors. Westpac is carefully evaluating all of the Report's recommendations.

Westpac believes an industry-wide solution is needed to address the issues raised in ASIC's report, to rebuild trust with consumers and ensure a sustainable advice and life insurance industry.

Recommendation 26

Improve guidance and disclosure in general insurance

Improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance.

Westpac supports this recommendation.

The Group has already developed website education tools and calculators to assist individuals select the appropriate level of home and contents insurance. Westpac would support an industry wide take up of these types of education tools, but believe this could be best achieved without the need for a prescriptive legislative framework.

Chapter 5 – Regulatory system

Recommendation 27

Regulator accountability

Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates.

Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.

Westpac supports the Inquiry's stated objectives for this recommendation, which are to:[45]

- Create a formal mechanism for Government to receive annual independent advice on regulator performance; and
- Strengthen the accountability framework governing Australia's financial sector regulators.

The creation of a new Financial Regulator Assessment Board is one mechanism through which to achieve these objectives.

Westpac supports the Inquiry's observations regarding the provision of clearer guidance to regulators in Statements of Expectation. A forward looking and risk-based approach to regulation is important, and Statements of Expectation could help direct the usage of regulatory resources to areas of greatest consumer or prudential concern.

Recommendation 28

Execution of mandate

Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews

Westpac supports this recommendation.

Recommendation 29

Strengthening ASIC's funding and powers

Introduce an industry funding model for ASIC and provide ASIC with stronger regulatory tools

Westpac supports the objective that ASIC has adequate funding and regulatory tools to deliver effectively on its mandate.

[45] p. 240, FSI Final Report, November 2014.

The final form of an ASIC industry-funding model should follow consultation with industry and be fairly attributed, with fees closely aligned to the cost of regulating. It should also be strongly linked to:

- A more transparent budget setting process with extensive consultation with stakeholders and final approval by the Government, consistent with Recommendation 28;
- A risk-based approach to regulation so that expenditure or resources are not overly directed towards areas of low regulatory risk; and
- Increased accountability measures, such as those contemplated in Recommendation 27.

Westpac addresses specific aspects of strengthening ASIC's regulatory toolkit in Recommendation 22 (the proposed proactive intervention power) and Recommendation 24 (banning individuals from managing a financial firm).

The Inquiry also recommends substantially higher maximum penalties in Australia for contravening laws governing financial sector conduct on the basis that maximum penalties in Australia are low by international standards. The Inquiry notes that in some overseas jurisdictions, the practice of extremely high penalties for financial firms *'risks creating inappropriate incentives for government and regulators unless revenue is separated and used for social or public purposes.'*[46]

An effective ASIC industry funding model mitigates the risk of these distortive incentives in Australia's financial system.

Recommendation 30

Strengthening the focus on competition in the financial system

Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in ASIC's mandate.

Westpac supports the rigorous application of competition considerations in the financial sector, and considers current regulatory arrangements sufficient to adequately address competition issues.

If periodic review of competition in the sector were implemented, it should be undertaken by the Australian Competition & Consumer Commission, which has the expertise and focus to address competition-related issues.

[46] P .252, FSI Final Report, November 2014.

Recommendation 31

Compliance costs and policy processes

Increase the time available for industry to implement complex regulatory change.

Conduct post-implementation reviews of major regulatory changes more frequently.

Westpac supports this recommendation as an effective mechanism through which to reduce costs, complexity and unanticipated negative implications associated with implementing regulatory change.

Appendix 1 – Significant matters

Recommendation 32

Impact investment

Explore ways to facilitate development of the impact investment market and encourage innovation in funding social delivery.

Provide guidance to superannuation trustees on the appropriateness of impact investment.

Support law reform to classify a private ancillary fund as a 'sophisticated or 'professional' investor, where the founder of the fund meets those definitions.

Westpac supports this recommendation.

Recommendation 33

Retail corporate bond market

Reduce disclosure requirements for large listed corporates issuing 'simple' bonds and encourage industry to develop standard terms for 'simple' bonds.

Westpac supports this recommendation.

Recommendation 34

Unfair contract term provisions

Support Government's process to extend unfair contract term protections to small business. Encourage industry to develop standards on the use of non-monetary default covenants.

Westpac does not believe that unfair contract term protections should be extended to small business standard form credit contacts. Consumer contracts and small business credit contracts are inherently different. Extending the current consumer protections to small business standard form credit contracts may have unintended consequences on credit appetite and access to finance for small and medium enterprises.

The banking industry should develop standards on the use of non-monetary default covenants. Westpac is currently working with the Australian Bankers' Association on a proposal to enhance the Code of Banking Practice in this regard. Westpac also considers there is an opportunity for Government to review the current legislative barriers to simplified, plain English disclosure.

Recommendation 35

Finance companies

Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from authorised deposit-taking institution deposits.

Westpac supports clear differentiation between investment products offered by non-ADIs and accounts offered by ADIs. APRA should determine the most prudent mechanism through which to enhance consumer understanding of this distinction, while supporting consumer choice.

Recommendation 36

Corporate administration and bankruptcy

Consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.

Westpac does not support amendments to the external administration regime that would move Australia towards a 'US Chapter 11' model. Australia's current voluntary administration regime is operating effectively, and this has been the conclusion of previous reviews.[47]

However, Westpac supports the concept of appropriate 'safe harbour' protections for legitimate restructuring efforts by firms in financial difficulty - that is, where directors and advisers are making a genuine effort to improve the position for creditors.

Westpac also supports 'ipso facto clauses' being suspended for a short period (perhaps up to 90 days) during restructuring efforts aimed at preserving value in the underlying business – on the proviso that banks are not required to continue to lend further monies to the borrower during that restructuring period.

Westpac has commented separately on the Government's exposure draft Insolvency Law Reform Bill 2014, which seeks to address the other complexities in Australia's external administration regime described in Recommendation 36.

Recommendation 37

Superannuation member engagement

Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance.

Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators

Westpac agrees with the recommendation regarding the publication of retirement income projections on member statements based only on the information held within that fund.

[47] For example, CAMAC, *Rehabilitating large and complex enterprises in financial difficulty,* October 2004.

Westpac endorses the Inquiry's view that *'where possible, all funds should provide meaningful retirement income projections on member statements.'*[48] The Inquiry also observes that this would benefit members at a *'relatively small cost to superannuation funds,'*[49] and, therefore, any regulatory guidance or requirement for the publication of statements should meet this objective. The publication of these projections should be on the basis of schemes' best estimation of income projection based on available information.

Westpac recognises that access to consolidated superannuation information from the ATO would provide an opportunity for superannuation funds to provide a more complete perspective of retirement income projections. Privacy and commercial confidentiality consideration regarding the sharing of private member data across the industry would need to be balanced with the potential benefits of enhanced retirement income calculators.

Consultation between ATO, ASIC and industry would be required to ensure those considerations are appropriately balanced and fund members' information is protected. Consideration should be given to the delivery of a consolidated retirement projection sitting with the ATO or the popular MyGov initiative.

Recommendation 38

Cyber security

Update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation, and progress public-private sector and cross-industry collaboration.

Establish a formal framework for cyber security information sharing and response to cyber threats.

Westpac supports this recommendation.

The Australian Government considers cybersecurity a national security priority,[50] and the finance sector is part of Australia's Critical Infrastructure.[51]The cybersecurity threat facing industry, particularly the financial services sector, has escalated dramatically in the last 18 months. Successful, public attacks on JP Morgan, Sony Pictures Entertainment (SPE), Target and others have indicated significantly increased attacker capability, and emboldened future attacks. This has been compounded by a broadening of attacker motives away from direct financial fraud, such as the apparently punitive attack on SPE.

A stronger, formal framework for information sharing on cybersecurity between Government and industry is needed. The rapid, broad-based sharing of critical cybersecurity information, both operational and strategic, would be beneficial to the cyber defence capabilities of both Government and industry.

This framework should also be developed to promote collaboration between industry organisations.

[48] p. 267, FSI Final Report, November 2014.
[49] Ibid.
[50] http://www.ag.gov.au/RightsAndProtections/CyberSecurity/Pages/default.aspx
[51] http://www.tisn.gov.au/Pages/Critical_infrastructure.aspx

In working towards the formal framework, Westpac recommends some initial steps to begin the sharing of information, such as an automated process for the Government to rapidly release information to industry (i.e. de-classification) and the pre-approval of key personnel in industry to access existing Government information (e.g. via pre-clearing to top secret positive vetting). In particular, Westpac suggests an exploratory workshop in which a very broad range of Government processes and information can be discussed with industry participants (appropriately cleared) and vice versa, to identify priority opportunities.

In developing a framework, industry representatives (again, appropriately cleared) should be placed into the operational processes of the Australian Cyber Security Centre. This will allow for industry information and operational context to enrich operational decision-making, and identify further opportunities for collaboration.

Recommendation 39

Technology neutrality

Identify, in consultation with the financial sector, and amend priority areas of regulation to be technology neutral.

Embed consideration of the principle of technology neutrality into development processes for future regulation.

Ensure regulation allows individuals to select alternative methods to access services to maintain fair treatment for all consumer segments.

Westpac supports this recommendation.

Regulation should be principles-based and functional in design. Continued technology innovation in financial services means that regulatory design should focus on outcomes rather than prescriptive requirements for the channel through which regulatory requirements are met.

In moving to technologically neutral regulatory design, close attention should be given to minimising compliance costs for industry and ensuring that neutrality is aimed at areas that maximise innovation and fair competition. The proliferation of new technologies (e.g. new 'wearable' smart devices) and the marketing of differentiated experiences (e.g. varying screen sizes/hardware in the Android ecosystem) can make complete technology neutrality challenging and designing for the principle difficult. The focus should be on enabling delivery through any means, rather than a requirement for complete standardisation.

From a customer's perspective, technology innovation should result in the same level of regulatory protection irrespective of the mode of technology delivery. The scope of this principle should include those participants traditionally external to the system using these innovations to cross into regulated markets. Westpac supports a level playing field in the effects and costs of regulation.

Recommendation 40

Provision of financial advice and mortgage broking

Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures

Westpac believes General Advice should be re-named 'General Financial Information.' The current delineation between factual information, General Advice and Personal Advice can be confusing regarding the true nature of 'general advice.'

The Inquiry suggests that General Advice should be replaced with a more appropriate, consumer-tested term to help reduce consumer misinterpretation and excessive reliance on this type of information by consumers. While not opposed to this approach, Westpac believes that 'General Financial Information' recognises that this information is not Personal Advice and, at the same time, goes beyond merely factual information.

Removing the label 'Advice' would also facilitate a clearer separation from Personal Advice, and enable the term Financial Advice and Financial Adviser to be clearly linked to the provision of Personal Advice.

Westpac does not support renaming General Advice based on 'sales' terminology, which was one of the options on which the Inquiry's Interim Report sought feedback. Much of the information provided through General Advice is factual information about a product or a service and is contained in regulated disclosure material. Westpac therefore does not believe the characterisation of this information as 'sales' is appropriate.

Regarding the disclosure of ownership structures, the Inquiry observes that *'although stakeholders have provided little evidence of differences in the quality of advice from independent or aligned and vertically integrated firms, the Inquiry sees the value to consumers in making ownership and alignment more transparent.'*[52]

Currently, financial services providers, including advisers, are required to document who they are acting for when providing their services, as well as:

- Details of the authorised representative or licensee;
- Information about the remuneration received by the adviser, employer, licensee or associates that might reasonably be expected to influence the adviser in providing advice; and
- Information about the association and relationships between the adviser or licensee or any related body corporate and any product issuers that might reasonably be expected to be capable of influencing the adviser or licensee.

Westpac acknowledges that this disclosure is not always effective in making it clear to the consumer who the ultimate owner of the licence is and supports further transparency in this area. We note that the Government has confirmed that this matter will be addressed in the ASIC Register and it is also addressed in Westpac Group's online register, 'Adviser View.'

[52] p. 272, FSI Final Report, November 2014.

In relation to mortgage brokers, Westpac supports greater disclosure requirements for mortgage broking ownership structures.

Recommendation 41

Unclaimed monies

Define bank accounts and life insurance policies as unclaimed monies only if they are inactive for seven years.

Westpac supports this recommendation.

On 18 March 2015 the Government announced it will amend the *Banking Act 1959* and the *Life Insurance Act 1995* to restore the time bank accounts and life insurance policies can be inactive before they are transferred to the Government from three years to seven years.

Recommendation 42

Managed investment scheme regulation

Support Government's review of the Corporations and Markets Advisory Committee's recommendations on managed investment schemes, giving priority to matters relating to:

Consumer detriment, including illiquid schemes and freezing of funds; and

Regulatory architecture impeding cross-border transactions and mutual recognition arrangements.

Westpac broadly supports a review of the Corporations and Markets Advisory Committee's (CAMAC) recommendations on managed investment schemes (MIS) in the areas of priority called out in the Final Report.

Reforms that establish a cohesive framework for the administration of insolvent schemes and/or insolvent scheme operators should be supported. Such a framework should delineate roles and responsibilities of scheme members, creditors and the scheme operator. In relation to modifying the existing broad reasonableness test of scheme liquidity, this should occur through industry consultation for the development of appropriate standard realisation periods across the spectrum of asset classes in which MISs commonly invest. Such an approach should also assist to reduce the susceptibility of certain kinds of funds to freeze withdrawals.

Westpac also supports the development of initiatives that result in mutual recognition of appropriately regulated collective investment vehicles.

Recommendation 43

Legacy products

Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investment sectors

Westpac supports this recommendation, and in addition believes consideration should be given to a broader product rationalisation framework across the financial services industry particularly in superannuation.

Any product rationalisation mechanism should be centred on a test of treating consumers fairly, as opposed to a test per individual investor. This is consistent with the duties of responsible entities and superannuation trustees with respect to classes of investors, and with life insurance policies generally involving groups of policyholders having standard policies.

Conclusion

The Inquiry’s recommendations constitute a valuable roadmap for the future of Australia’s financial system. It is now important that the financial system’s stakeholders engage constructively on workable, implementable reforms to complement our already well-functioning system and its support of Australia’s growth.

Ultimately, the financial system exists to meet the needs of all Australians. It plays a vital role in the economic and social fabric of the nation. It continues to deliver on this objective well, supporting a sustained period of economic growth and national prosperity, and helping Australia withstand ongoing financial instability globally.

The response to the Inquiry’s Final Report is a timely opportunity to consider how Australians will continue to rely on the financial system in the future. Great shifts such as demographic change, technological innovation and globalisation will bring significant change. They create opportunities for greater customer empowerment and invigorated customer experience, with the challenge of ensuring the continued stability and resilience of the system.

As the pace of change accelerates, confidence in the operation of the financial system, certainty in its regulatory framework and trust in its institutions, should continue to be key aspirations for the system’s stakeholders. These principles are the bedrock of our system.

Westpac will continue to assist regulators and Government in ensuring Australia’s financial system delivers these goals.