
SECOND SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

Westpac's response to the Interim Report of the Financial System Inquiry

Westpac Banking Corporation

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Chapter 1 – Executive Summary

The Westpac Group (Westpac) supports the overarching objective of the Financial System Inquiry (Inquiry) to ensure the financial system supports Australia's growth. Westpac welcomes the opportunity to respond to the Inquiry's Interim Report (Interim Report).

In this Second Submission to the Inquiry (Second Submission), Westpac responds to the policy options and requests for information contained in the Interim Report. From the range of those policy options, Westpac's evidence-based responses focus on the following:

- Developments in housing finance and regulatory capital requirements for mortgages;
- Vertically integrated business models;
- Bank funding of credit growth;
- The efficiency and stability of the superannuation sector;
- The issue of 'too big to fail' (TBTF) and moral hazard risk;
- Consumer protection, specifically disclosure and financial advice matters; and
- Retirement income policy.

Developments in housing finance and regulatory capital requirements for mortgages

Westpac does not believe that the growth in the Australian housing finance market poses an undue systemic risk to the financial system. Based on international experience, particularly in the USA in the period before the Global Financial Crisis (GFC), there are clear factors that indicate when such a systemic risk is present. These factors are listed below, but evidence presented in this submission demonstrates that they are largely absent in Australia:

- Over-indebtedness on the part of borrowers;
- The prevalence of high-risk loans on non-commercial terms; and
- Supply-driven concentration of housing assets on bank balance sheets.

Rather, Westpac believes that the increase in housing finance in Australia has been primarily demand-driven and is underpinned by sound economic fundamentals. These demand factors, rather than supply side factors (such as risk weighting arrangements), are at the heart of the growth of housing finance.

Australian bank mortgage portfolios are diversified and low risk, and regulatory capital requirements are conservative. Both historical precedent and rigorous stress testing have proven that even a dramatic down turn in house prices would be well within Westpac's loss absorption capabilities.

Westpac agrees with the observation of the Interim Report that enhanced credit risk modelling capabilities are an essential feature of the financial system. Regulatory capital requirements for lending portfolios should ensure banks have the capacity to absorb losses in the event of severe stress. By allowing banks to model their risks at a transactional level, the Internal Ratings-Based (IRB) capital approach creates incentives to more effectively analyse and manage lending risks. For both Advanced IRB and standardised banks, loss experience on mortgage portfolios is low over a wide range of economic circumstances.

These factors mean that there is no undue risk to the financial system from the growth in housing finance, and no clear need for further regulatory intervention in the housing finance market.

As the Australian Prudential Regulation Authority (APRA) has suggested, changes to capital requirements under Basel II have not been a key driver of changes in housing lending growth or market share in the post-GFC environment.

However, if there is a view that capital requirements overstate the risk of the mortgage portfolios of standardised banks, Westpac suggests that some form of targeted assistance for Authorised Deposit-Taking Institutions (ADIs) currently utilising the standardised model to attain existing IRB accreditation would be appropriate. This would be consistent with the principle of supporting stability by improving risk management in the financial system, through an increased use of risk sensitive models.

Vertically integrated business models

The Interim Report discusses vertical integration in the context of competition in the mortgage broking industry, and in wealth management and superannuation.

There is no evidence that vertical integration is having any adverse effect on competition. Indeed, vertical integration has resulted in many efficiencies and benefits for consumers. It has also deepened relationships with customers, meaning providers are highly motivated to provide a high-quality service offering through all of their interactions with their customers, or risk losing such relationships entirely.

The mortgage broking industry exhibits many of the factors associated with a highly competitive market - it is very fragmented with a high degree of contestability between broking platforms - thus leaving no room for any one vertically integrated provider to distort competition.

Australia's wealth management sector is built on an open architecture approach with a diverse range of wealth management products, provided by a range of suppliers with strong signs of price competitiveness. Platforms do not discriminate in favour of their own products, if they did, third party advisers would defect to other platforms given:

- the range of alternatives for product owners; and
- impact on the value of the platform.

In addition, existing mechanisms comprehensively regulate any perceived conflicts of interest arising from vertically integrated business models.

Bank funding of credit growth

Westpac believes that ensuring the financial system has the capacity to support optimal growth in all economic conditions should be the most important objective of the Inquiry.

The capacity of Australia's banks to fund credit growth, particularly in a higher credit demand environment, must be closely considered in meeting this objective. In certain realistic economic conditions, the demand for credit may exceed its available supply from the banking system. While the demand and supply of credit will necessarily adjust to equilibrium, the adjustment will come through higher prices, which is likely to negatively impact the substantial number of borrowers that rely on bank credit.

A more efficient approach is to ensure that the banking system has appropriate access to high-quality funding sources. This is essential for the customers that banks support, particularly individual households and small and medium enterprises (SMEs). Measures to equalise the tax treatment of deposits and other competing savings options would be effective in enhancing the high-quality funding available to the banking system. Encouraging the investment of superannuation into bank deposits and fixed income securities would also help to achieve this goal.

The efficiency and stability of the superannuation sector

Westpac supports the Inquiry's focus on the superannuation system as a vital aspect of its review of Australia's financial system. The growth in superannuation is one of the most important developments in the financial system since the Wallis Inquiry, and has broad implications for the economy and the welfare of all Australians.

Given these broad implications, Westpac supports the creation of an independent statutory advisory body to provide oversight and policy advice to government on superannuation.

In relation to the efficiency of superannuation, recent and ongoing reforms such as MySuper, SuperStream and Future of Financial Advice (FoFA) are having a substantial impact on the Australian superannuation landscape. These legislative reforms have come with a substantial cost to superannuation providers and will take several years before all of the potential benefits are realised.

Indeed, there is evidence MySuper has already placed downward fee pressure on superannuation providers and Westpac believes this will continue as the reforms fully take effect.

Westpac also believes that the realisation of some MySuper benefits could be accelerated through both the removal of anti-competitive default fund provisions, and through the creation of a product rationalisation framework that can assist to modernise the sector by rationalising legacy products.

Westpac rejects much of the analysis and conclusions of the recent Grattan Institute report into superannuation fees and competition. The report fails to make an appropriate comparison with similar international defined contribution schemes, and ignores the competitive impact MySuper is already having and will have over time. Any consideration of further change to these arrangements should be deferred until at least 2020, on the basis that the current reforms will not be fully implemented until mid-2017.

Westpac believes that suitability remains the most important policy consideration in relation to self-managed superannuation funds (SMSFs). Given the different levels of consumer protection across APRA regulated funds and SMSFs, Westpac supports the need for a clearer requirement before the establishment of an SMSF can be recommended.

Moreover, the current level of oversight and analysis of the systemic implications of the SMSF sector is insufficient given its size and continued growth. Westpac continues to encourage the Inquiry to consider ways that these matters can be addressed.

Westpac acknowledges there are systemic benefits to a large unleveraged superannuation savings pool, which can act as a stabiliser in times of stress. This calls into question the leverage scope currently available to SMSFs.

The issue of 'too big to fail' and moral hazard risk

The capacity of private institutions to fail is fundamental to the operation of a market-based financial system. There should be no 'guarantee' of individual institutions in the financial system.

Westpac strongly supports the policy objective that government liquidity support of the financial system in the event of a crisis should operate in a way that minimises the risk taxpayers are directly exposed to loss.

Australia's financial system already has strong features that minimise the risk of taxpayer loss, which are a function of conservative regulatory settings and prudent bank management:

- Australia's major banks are very well-capitalised, both in absolute terms and when compared with global peers on a consistent basis;
- Prudential supervision in Australia is conservative, such as in the definition and measurement of capital; and
- There is an intense level of supervision of domestic systemically important banks (D-SIBs), which aims to mitigate any moral hazard risk.

Since the GFC, Australia's major banks have focused on increasing the quantity and quality of capital, increasing liquidity holdings and improving the resilience of their funding models. In many cases this has occurred in anticipation of, rather than as a response to, global regulatory change. As a result, the banking sector is now significantly stronger than it was before the crisis.

Any further policy options to address the issue of TBTF need to be justified on the basis that there is an additional, unknown vulnerability in Australia's financial system beyond that which is contemplated in existing stability settings. There is no clear evidence of this. While measures were undertaken by Australian regulators and Government to support the banking system during the GFC, they were implemented without any call on the taxpayer, or disruption to the support banks provided to economic growth. The need for those measures arose from dislocation in international capital markets creating liquidity risk for Australia as a net importer of capital. The need did not arise through a lack of stability in Australia's financial system through inappropriate lending or other vulnerabilities. Measures to increase sources of high-quality funding to the banking system (and thereby minimise liquidity risk due to reliance on offshore markets) are discussed in Chapter 3.

Further, there is no evidence of market-based pressure from international investors for Australia to implement idiosyncratic measures to further address TBTF. Australia is not disadvantaged by its existing stability settings and approach to TBTF as an importer of capital.

Any further policy options to address TBTF should therefore closely consider Australia's unique circumstances and existing settings. They should also consider the efficiency of the financial system, the credit rating of Australia's banking system and the capacity of the financial system to support economic growth.

In relation to each policy option, Westpac's position is summarised below:

- Ring-fencing - The modest scale of Australian banks' investment banking activities and discretionary investment portfolios, and broader regulatory risk-mitigation measures, reinforce the current lack of justification for any costly and inefficient ring-fencing measures;
- Further increasing D-SIB capital requirements - Increased capital comes at a cost, which is ultimately reflected in higher costs for borrowers. There is no clear basis on which to require additional capital holdings. Australia's D-SIBs are very well-capitalised to absorb losses, and are in the upper range of capitalisation globally. Further, as liquidity support of the financial system is the primary nature of government support in Australia, it is not clear that increasing capital requirements further will necessarily reduce the call on government in a liquidity crisis;
- Imposing losses on creditors ('bail-in') - Westpac believes any bail-in regime for Australia should be carefully designed for domestic circumstances in consultation between Government, regulators and the banking industry. Any recommendations regarding bail-in should also be undertaken with the benefit of the outcomes of the G20 Brisbane Summit - there is no clear advantage in Australia being an 'early-mover' in implementing bail-in measures compared with the rest of the world;
- Resolution powers and pre-planning - Westpac supports the development of a sound resolution framework in Australia, and will work closely with regulators to develop this framework in a manner that is appropriate for Australia's financial system; and
- Stress-testing - Westpac recommends the increased use of stress testing as a sound means of assessing the strength of Australia's banking system and the need for any additional regulatory and prudential measures to deal with TBTF.

The policy options above are inter-connected and should not be considered in isolation. Therefore, ultimately, Westpac believes the totality of the financial system's stability settings are most important in managing TBTF and moral hazard risk, rather than any one, individual policy measure.

Consumer protection – disclosure and financial advice

The financial system's current disclosure regime has led to increased costs and, in many instances, voluminous documentation that does not enhance customer understanding.

Notwithstanding these concerns, Westpac believes disclosure should remain the fundamental foundation of consumer protection in Australia's financial system. As an overarching principle, regulation of financial products should provide effective consumer protection while continuing to allow consumers to take risk. In supporting this goal, Westpac believes it is important that the current disclosure regime is improved to provide accessible information to consumers, which supports informed choice within a statutory framework of product suitability, and a framework of regulatory oversight.

To this end, Westpac believes Government and regulators, in consultation with the financial services industry, should undertake a review of disclosure to design more consumer-friendly disclosure documents based on applied research. Such an approach is preferable to more interventionist regulation that inhibits innovation, for example, further regulation of product design or distribution.

Affordable, professional and quality financial advice is also vital to ensuring beneficial financial outcomes for individual consumers. Improving the training and capabilities of those who provide advice is essential to maintain trust and positive consumer outcomes.

Westpac supports significantly raising education standards and establishing a public register for financial advisers as a means to improve quality and transparency in the industry. A new national competency framework, overseen by a new Self-Regulatory Organisation, is required to begin to place financial advisers on a similar professional footing to lawyers and accountants.

Westpac believes there is potential to improve consumer understanding by more clearly labelling what is today termed 'General Advice' to 'General Financial Information,' and more explicitly limiting who can hold themselves out to be a 'financial adviser'.

However, Westpac does not support the introduction of regulatory distinctions between different business models or advisers, on the grounds that such labels are not meaningful and may be misleading if incorrectly interpreted by consumers.

Retirement income policy

Westpac believes the retirement income system should aim to deliver a level of income replacement in retirement of up to 65% to 70% for the majority of Australians. In doing so, the system should also substantially offset the cost of the Age Pension by ensuring Australians can self-fund their retirement to the maximum extent possible.

Westpac does not support the suggestion that the purchase of a specific income stream at retirement should be made compulsory. Further, Westpac believes default models risk entrenching further disengagement and, in doing so, reducing competition and resulting in lower retirement incomes for members. If a default system were considered, it should be principles-based and supported by an integrated advice model which provides targeted, simple advice to members.

Rather than compulsion or default, Westpac proposes consideration of a retirement income model that includes a combination of a flexible default income stream, coupled with appropriate policy incentives. This model, discussed in detail in Chapter 8, centres on incentivising as many Australians as possible to provide a minimum level of income up to the value of the Age Pension for the duration of their retirement. The model contemplates that it would still be possible for small balances to remain in the default (or select from other products) without penalty.

The model would encourage innovation in retirement income products, to help achieve the objective of 65% to 70% income replacement in retirement. It would also help to ensure that the fiscal objective of superannuation is met.

Aide-memoire to reading Westpac's Second Submission

Westpac's response to the policy options raised in the Interim Report is in each case provided directly under an extracted grey box of those options, reflecting the format of the Interim Report:

[Westpac Second Submission reference]

[Cross-reference to Interim Report reference]

- No change to current arrangements
- Policy option 1
- Policy option 2

[Westpac response]

The analysis and recommendations of Westpac's Initial Submission are not repeated, but are referred to where relevant.

To aid cross-referencing, Westpac's Second Submission adopts the same chapter numbering as the Interim Report. The 'Key Issues and Insights' of each chapter of Westpac's submission also appear before the beginning of each chapter.

Chapter 2 – Competition

Westpac Key Issues and Insights

Housing finance market

- Westpac does not believe that the growth in the Australian housing finance market has been unsustainable or poses an undue systemic risk to the financial system. The factors that would demonstrate such a systemic risk (such as those present in the USA before the GFC) are not present in Australia's market.
- There is therefore no compelling evidence that further regulatory intervention in the housing finance market is required.
- The increase in housing finance has been primarily demand-driven and based on sound economic fundamentals such as high and sustained income growth and macroeconomic stability.
- Australian household net debt to income ratios have decreased since the GFC, once the impact of mortgage offset accounts is considered.
- There is no evidence of housing finance crowding out business finance. Rather, recent years have seen a decline in demand for business finance and a deliberate deleveraging following the GFC.

Regulatory capital requirements for mortgage lending

- Australian bank mortgage portfolios are diversified and low risk, and regulatory capital requirements are conservative.
- Both historical precedent and rigorous stress testing have proven that even a significant down turn in house prices would be well with Westpac's loss absorption capabilities.
- Regulatory capital requirements for lending portfolios should ensure banks have the capacity to absorb losses in the event of severe stress. By allowing banks to model their risks at a transactional level, the IRB capital approach creates incentives to more effectively analyse and manage lending risks.
- Westpac suggests that some form of targeted assistance for ADIs currently utilising the standardised model to attain existing IRB accreditation would be appropriate.

Vertically integrated business models and competition

- While banking and wealth management are experiencing increased levels of vertical integration there is no evidence that such integration is having an adverse impact on competition. Indeed, vertical integration has provided benefits to customers.
- The mortgage broking industry exhibits many of the factors associated with a highly competitive market - it is very fragmented with a high degree of contestability between broking platforms - thus leaving no room for any one vertically integrated provider to distort competition.
- Likewise, Australia's wealth management sector is built on an open architecture approach with a diverse range of wealth management products, provided by a range of suppliers with strong signs of price competitiveness.

Chapter 2 – Competition

Westpac notes the Inquiry's observation that the banking sector is competitive, albeit concentrated. Westpac's Initial Submission presents evidence that supports this observation.

There are two issues within the theme of competition that are discussed in detail in the Interim Report, and on which Westpac provides a detailed response:

- The housing finance market and differential treatment of capital for mortgage lending under the Advanced IRB and standardised approaches; and
- Vertically integrated business models.

Westpac also provides responses to various other policy options raised in Chapter 2 of the Interim Report.

2.1 Developments in the Australian housing market

Developments in Australia's housing market, and the extent to which that market poses a systemic risk, should be considered together with features of stability of housing finance in Australia. Regulatory capital requirements are a key feature of stability.

For this reason, this section addresses both the request for information raised at page 2-57 of the Interim Report (in Chapter 3 Funding), and the policy options regarding regulatory capital requirements listed at page 2-11 of the Interim Report:

(2-57)

What measures can be taken to mitigate the effects of developments in the housing market on the financial system and the economy? How might these measures be implemented and what practical issues would need to be considered?

(2-11)

- No change to current arrangements
- Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation
- Increase minimum IRB risk weights
- Introduce a tiered system of standardised risk weights
- Lower standardised risk weights for mortgages
- Allow smaller ADIs to adopt IRB modelling for mortgages only

In Westpac's view, there is no compelling evidence to suggest that the growth in the Australian housing finance market poses an undue risk to the financial system.

Having regard to experience in other nations, particularly the USA, the existence of such an undue risk would be demonstrated by:

- Over-indebtedness on the part of borrowers;
- The prevalence of high-risk loans on non-commercial terms, in Australia commonly known as ‘non-conforming’ loans (or ‘sub-prime’ loans in the USA); and
- Supply-driven concentration of bank balance sheets to housing assets to the exclusion of business lending.

This section assesses the presence of each of these factors in Australia, and presents evidence that suggests none of them poses substantial risk to the financial system.

Rather, Westpac believes that the increase in housing finance in Australia has been primarily demand-driven and underpinned by sound economic fundamentals, based on several objective economic indicators outlined below. These demand factors, rather than supply side factors (such as risk weighting arrangements), are at the heart of the relatively faster growth rate of housing loans compared with finance for other activities.

Moreover, the evidence does not support the proposition that housing finance is ‘crowding out’ finance for other activities,¹ such as business lending. Economic indicators outlined in this chapter demonstrate that the decline in business credit since the GFC has largely been a consequence of business deleveraging (an entirely rational risk management response to volatile and uncertain business conditions) - and not banks ‘preferring’ housing finance to business lending.

These factors support the view that there is no undue risk to the financial system from the growth in housing finance, and no clear need for further regulatory intervention.

2.1.1 Demand-driven factors of housing finance growth

In Australia, there are key long-term developments that have driven growth in demand for housing finance. They include:

- Consumer preference for residential property - owning a home has a very strong cultural resonance in Australia and is a significant driver of overall household debt. Many Australians also see residential property as a key element of their long-term investment strategy;
- High and sustained income growth - Australia has not experienced a recession for more than 20 years. This is a very long period of sustained growth, and a far longer period of continuous growth than most advanced economies have experienced. In contrast, some countries that have experienced marked slowdowns or periods of financial distress have seen falls in household indebtedness to income ratios during those periods (as illustrated in Figure 2 in the case of the UK, Sweden and France);
- Low inflation and nominal interest rates - one of the key factors in determining both how much a household will desire to borrow, and how much a financial institution will be prepared to lend, are the loan repayments as a proportion of disposable income. Generally, lower levels of inflation will lead to lower nominal interest rates, and greater household borrowing capacity. Australia, along with most advanced economies, is experiencing a sustained period of historically low inflation and, consequentially, low nominal interest rates;

¹ p. 2-55, FSI Interim Report.

- Regulation - the tax treatment of the family home and investment properties has contributed to higher house prices in Australia and, therefore, a greater demand for loans for both residential and investment properties. This has been a long run phenomenon. First home buyers grants have tended to increase household demand for loans for residential properties;
- Lower unemployment - While unemployment has varied quite significantly during the past 30 years, it has trended downwards and has remained at historically low levels over the past decade. This has tended to increase both the demand for debt by households and the willingness of financial institutions to lend to households; and
- Macroeconomic stability - Lower volatility in key macroeconomic indicators (such as interest rates, unemployment and inflation) was a feature of almost all major advanced economies for much of the two decades preceding the GFC. Australia's sustained benign conditions have also reduced the likelihood of default.

On the 'supply' side, deregulation and financial innovation have been important drivers of higher rates of household indebtedness. The removal of credit rationing in the early 1980s following the Campbell Inquiry, along with the removal of interest rate caps in the 1990s, were significant factors in the growth in household indebtedness, and also the rising level of mortgages on banks' balance sheets.

Financial innovation, while a supply-side factor, has improved financial organisations' ability to assess risk. This has allowed more household demand to be met, without seeing a rise in default rates. Unlike other markets, the risk appetite of banks for housing finance has not changed, nor is there any evidence that greater credit availability has increased the supply of housing through 'non-commercial' lending (discussed in section 2.1.3 below).

2.1.2 Indicators of systemic risk – household over-indebtedness

The first factor that could suggest the presence of systemic risk due to housing finance is household over-indebtedness. However, there is no strong evidence of household over-indebtedness in Australia. Rather, evidence presented in this section suggests that the true level of household indebtedness has fallen since the GFC, is based on sound economic fundamentals, and is generally in line with long-term and global trends.

The Interim Report makes the observation that:

*'Since 1997, household leverage has increased from debt equivalent to around 0.8 years of gross disposable income to around 1.5 years of income in 2008.'*²

There has been a significant shift in the behaviour of Australian households over the last five years, resulting in a major shift in household leverage. Households have taken a more cautious approach to their finances, resulting in a sharp and sustained rise in household savings rates, slower credit growth and faster prepayment rates on mortgages.

² p. 2-51, FSI Interim Report.

To illustrate this, Figure 1 shows a number of ratios to household disposable income (using data from the Australian Bureau of Statistics (ABS)):

- Gross household debt;
- Total housing debt;
- Gross household debt net of direct holdings of cash and deposits; and
- Accumulated household savings for each quarter since 2007, which is household disposable income minus consumer spending and depreciation.

Figure 1. Australian households: debt to income ratio (%)³

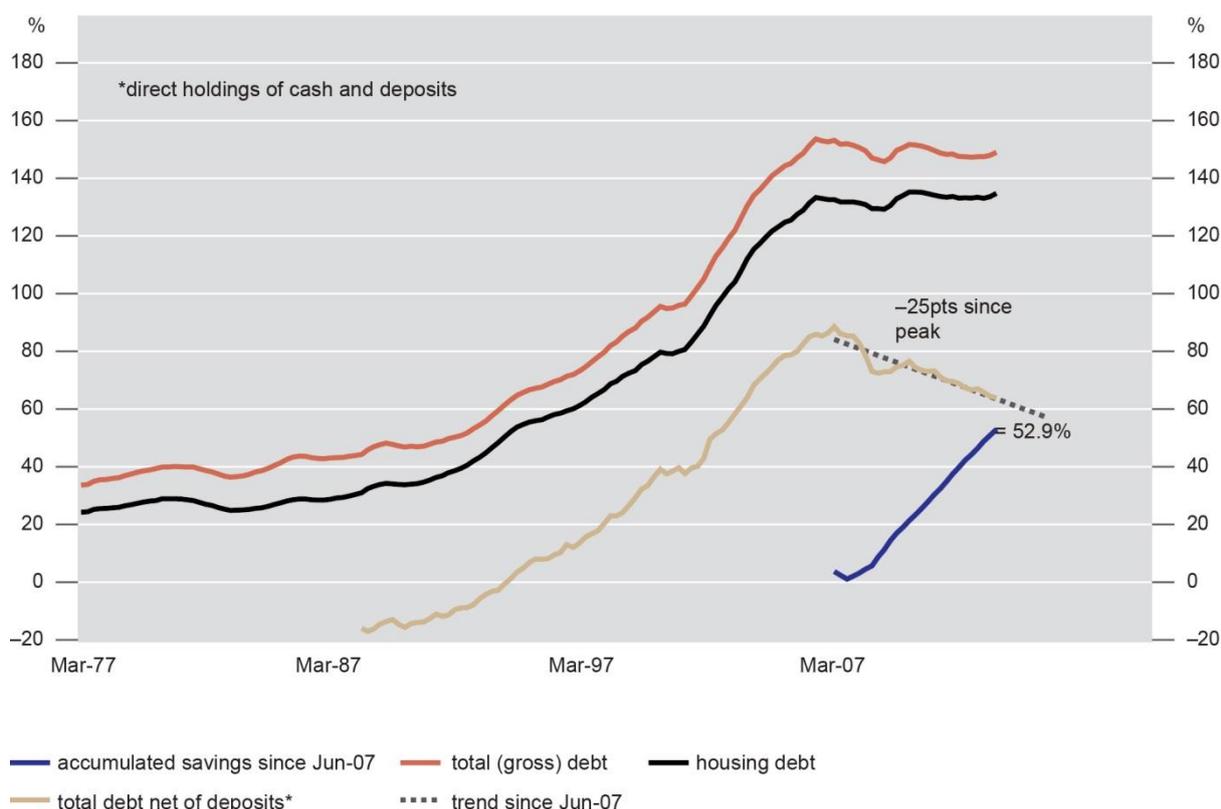


Figure 1 shows that the total household debt to income ratio has remained steady since 2007. However, this measure excludes funds held in mortgage offset accounts, and therefore understates the shift towards deleveraging.

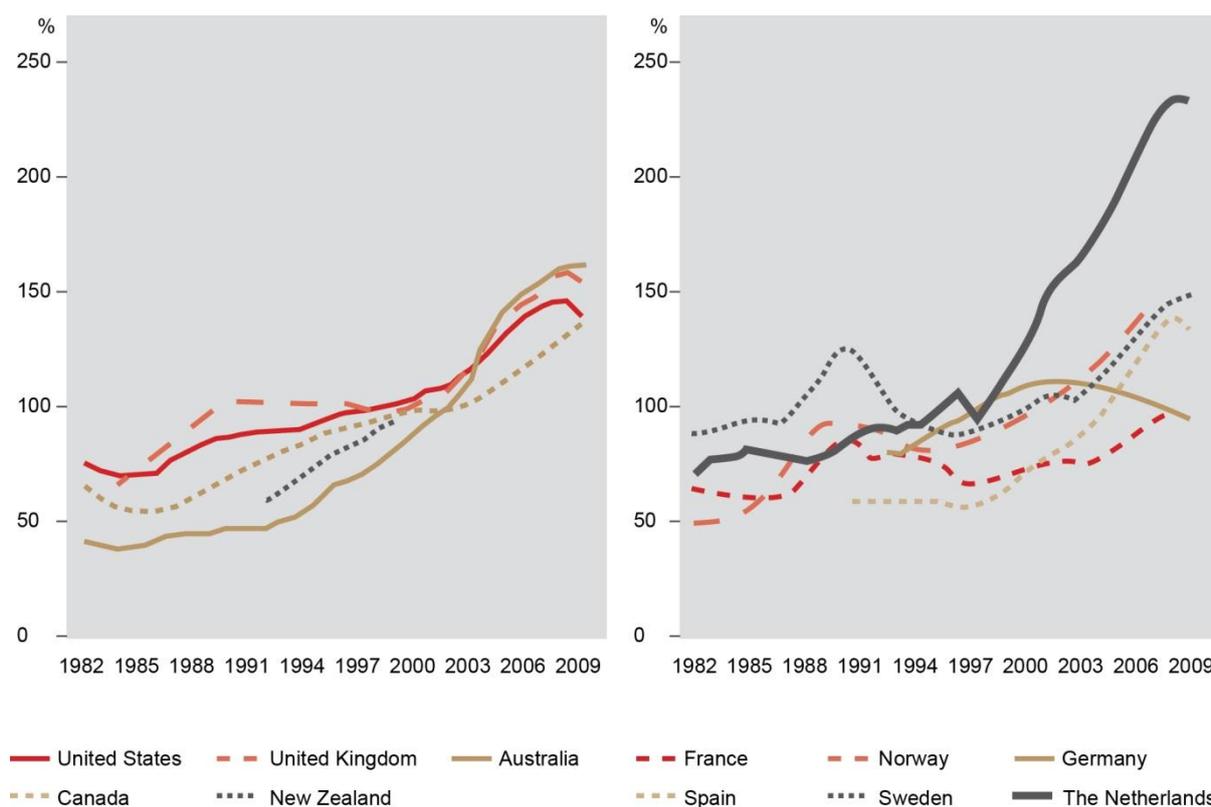
Mortgage prepayments are often made through the accumulation of funds in mortgage offset accounts, which are technically classified as deposits rather than a reduction in loan principal. As shown in Figure 1, there has been a sharp increase in households' total holdings of cash and deposits since 2007. This increase reflects significant household deleveraging, along with several other factors such as portfolio reallocations, higher deposit rates due to intense competition and the accumulation of savings by households that do not hold a mortgage.

³ Westpac 2014 Interim Results Presentation and Investor Discussion Pack, at p. 131

While increased accumulated savings do not automatically flow into mortgage offset accounts, this trend has contributed to the pronounced decline of 25 basis points in households' net debt to income ratio since 2007. This supports the view that there has been a trend of household deleveraging.

Figure 2 shows that household indebtedness has risen sharply over the past 30 years in most advanced economies. Australia's ratio (not accounting for the funds held in mortgage offset accounts) has increased faster than the average, but in line with other economies such as the Netherlands, Norway and the UK.

Figure 2. International comparison of household debt to disposable income ratios⁴

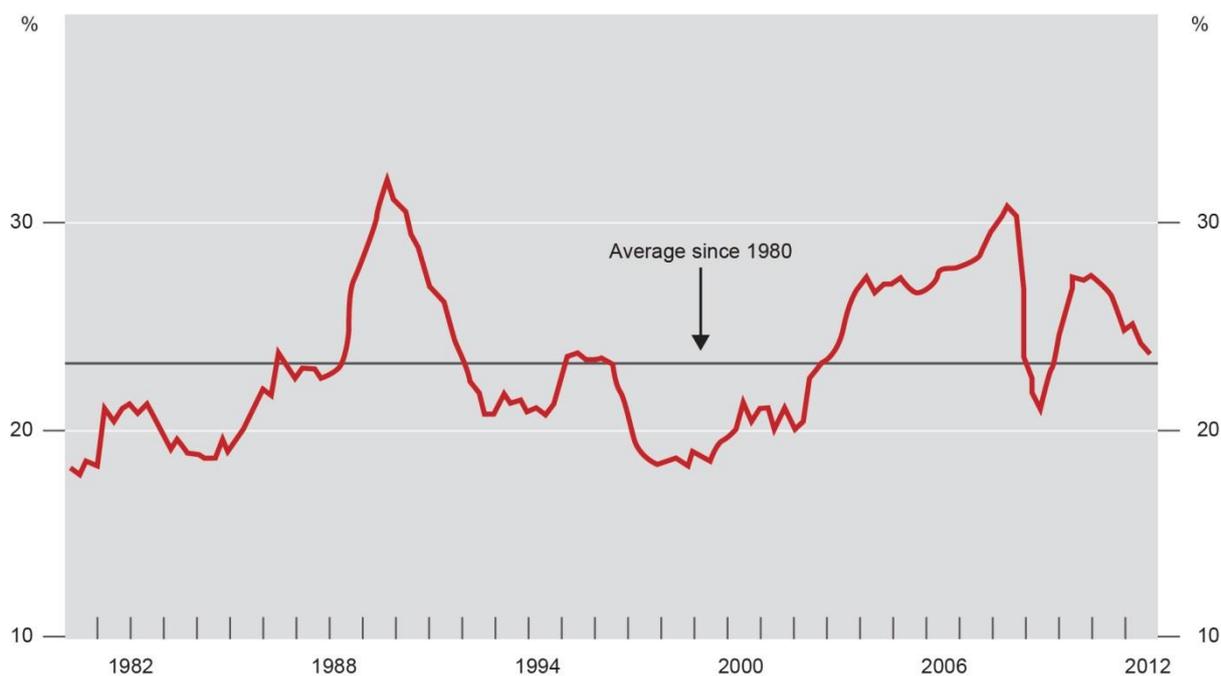


The rising household indebtedness ratio, occurring globally, is likely due to a range of factors common across advanced economies. Many of these factors, such as high and sustained income growth, low unemployment rates, low nominal interest rates and financial sector deregulation, have been positive developments for economies. Higher debt levels associated with such factors should not, in Westpac's view, be considered problematic.

As can be seen in Figure 3, household repayments on new housing loans, as a proportion of disposable income, have fallen since the GFC, and are currently almost identical to the long run average. This supports the view that while the sum of housing finance may have increased, this has not necessarily resulted in borrowers taking on excessive risk, and that the current level of serviceability appears sustainable compared to long run averages.

⁴ Bloxham, Paul and Christopher Kent, "Household Indebtedness", *The Australian Economic Review*, vol. 42, no. 3, 327-339, 2009

Figure 3. Repayments on new housing loans as a percentage of household disposable income⁵

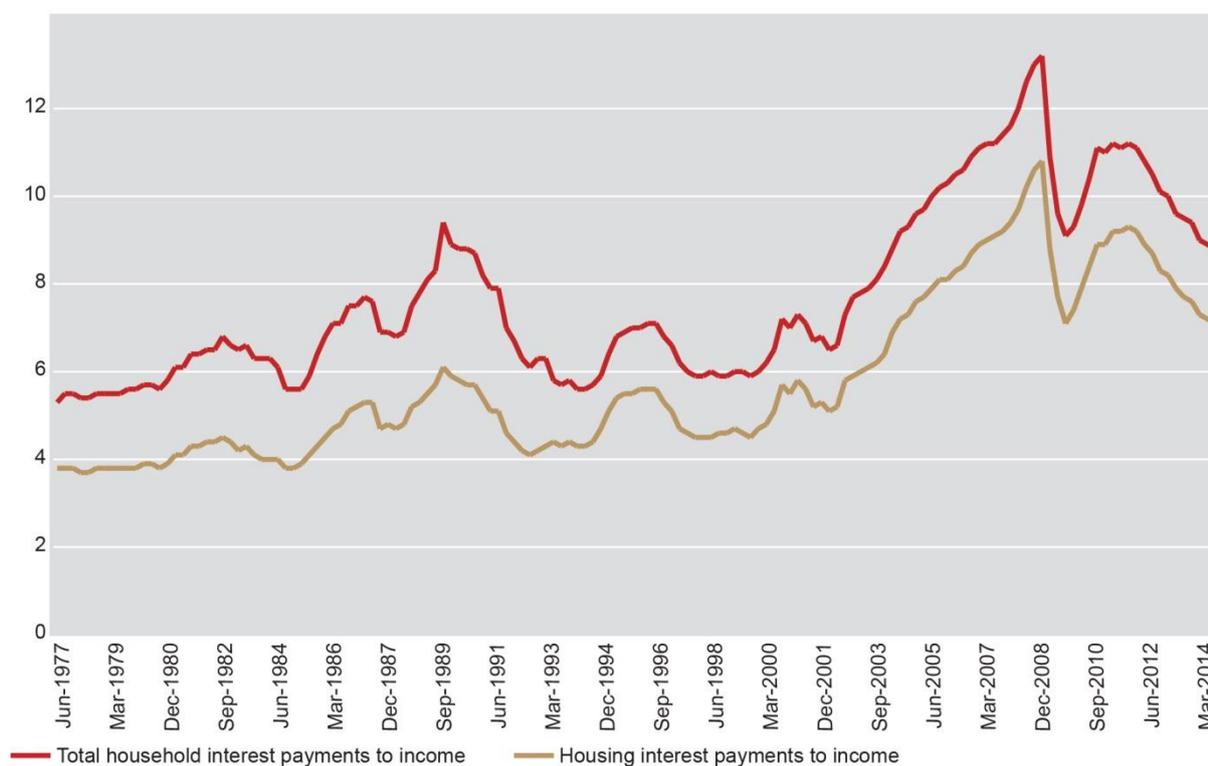


* Housing loan repayments calculated as the required repayment on a new 80 per cent loan-to-valuation ratio loan with full documentation for the nationwide median-priced home; household disposable income is before interest payments
Sources: ABS; APM; CBA/HIA; RBA; REIA; RP Data-Rismark

The capacity of households to service debt, rather than nominal debt levels per se, is the most important indicator of sustainability. There has been a significant improvement in household debt serviceability since the GFC. Figure 4 shows household debt serviceability for Australia since 1977. Overall household debt serviceability is largely driven by changes in housing debt serviceability. Since the GFC, housing debt serviceability has trended downwards to levels that are similar to the long run average.

⁵ Fox, Ryan and Richard Finlay, "Dwelling Prices and Household Income", *RBA Bulletin*, December Quarter 2012

Figure 4. Household debt serviceability in Australia: 1977-2012⁶



2.1.3 Indicators of systemic risk - 'non-commercial' lending

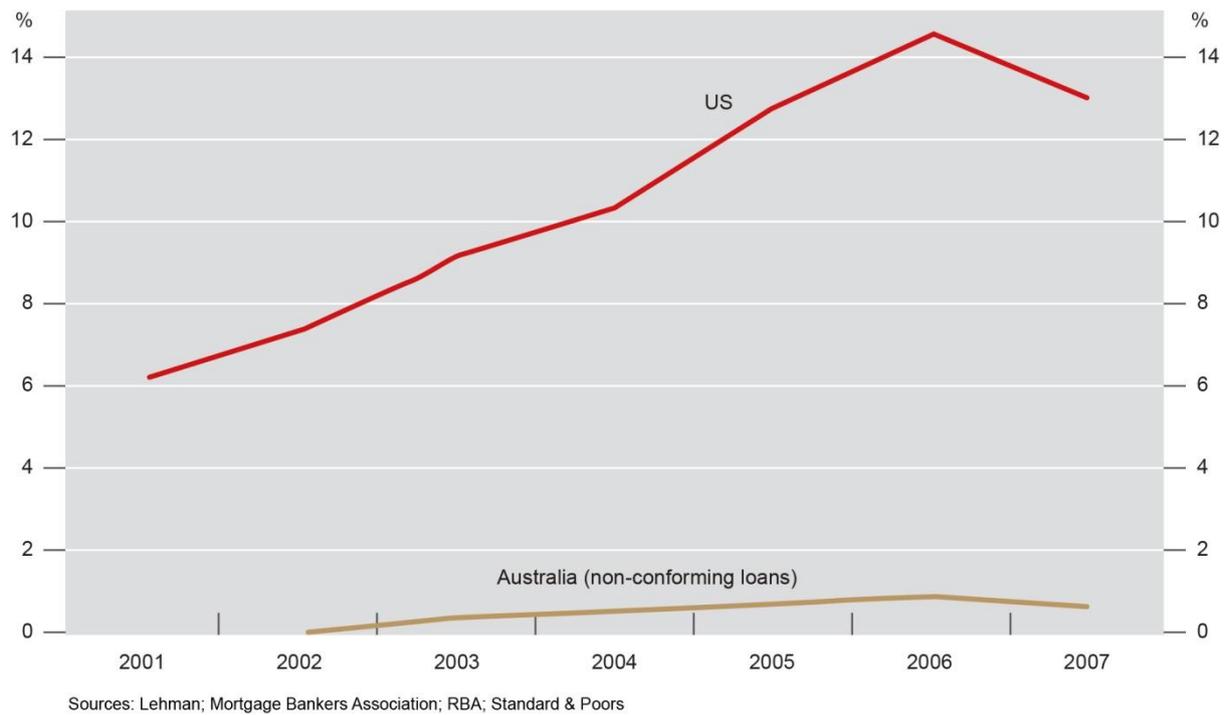
A second indicator of systemic risk due to housing finance would be the prevalence of non-commercial lending.

Borrowers under high-risk 'non-conforming' loans may have adverse credit histories, or may be already delinquent at the close of the transaction. In the US market, these types of loans are known as 'sub-prime.' These loans may also have unusual deposit sources, unusual security properties, or otherwise fail to meet the standards of prime lenders.

In Australia, the proportion of 'non-conforming' loans as a proportion of total housing loans is very low both in absolute terms, and relative to the size of the 'sub-prime' market in the US. This is illustrated in Figure 5, with reference to the years leading up to the GFC.

⁶ RBA, Statistical Tables: <http://www.rba.gov.au/statistics/tables/index.html>
Table E2: Household Finances – Selected Ratios

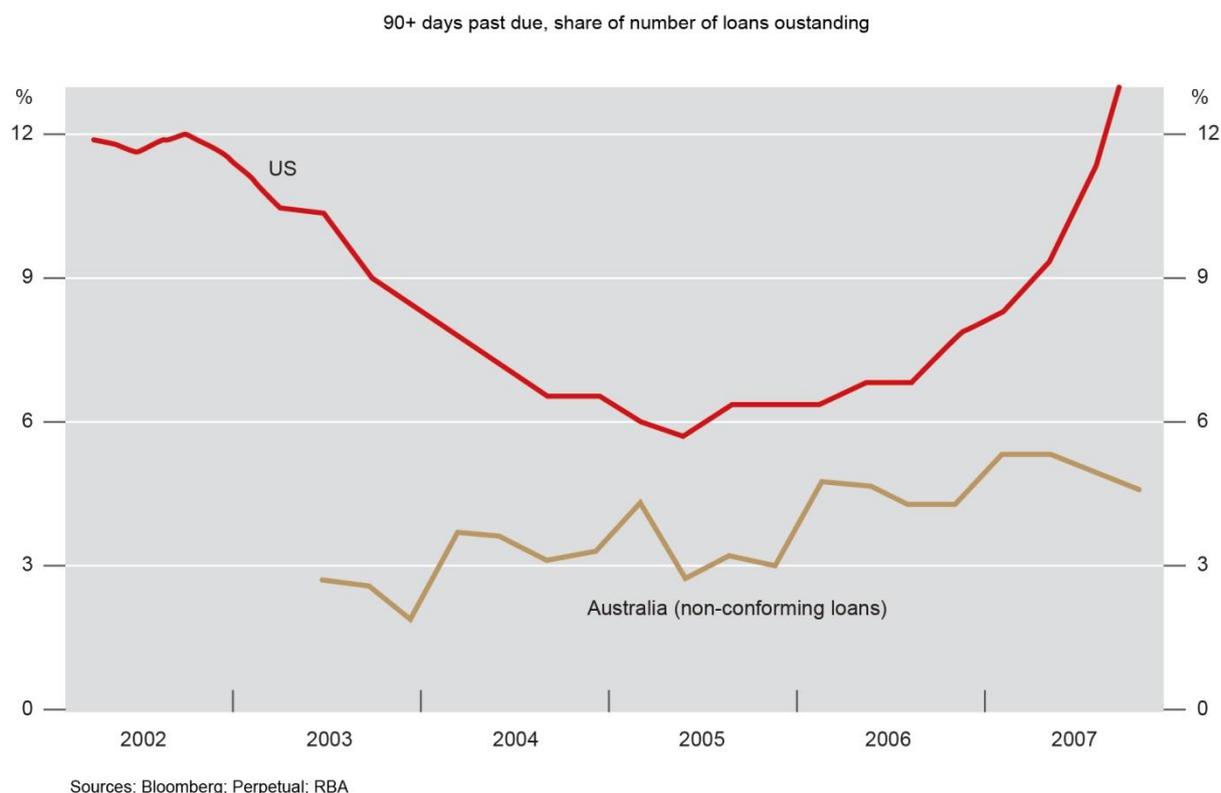
Figure 5. The size of sub-prime housing markets in the US and Australia (as a share of outstanding mortgages)⁷



Of the small proportion of ‘non-conforming’ loans in Australia, evidence shows that the arrears rate was much lower than that of ‘sub-prime’ loans in the US in the period leading up to the GFC. This is illustrated in Figure 6.

⁷ RBA, DeBelle, Guy. ‘A Comparison of the US and Australian Housing Markets, address to the Sub-Prime Mortgage Meltdown Symposium, Adelaide, 16 May 2008. See graph 1.

Figure 6. Pre-GFC arrears rates on sub-prime mortgages US vs Australia⁸



Activity in the ‘non-conforming’ loan sector remains a small share of total lending, at approximately 0.2% of total housing credit in July 2013, and the Reserve Bank of Australia (RBA) has stated that:⁹

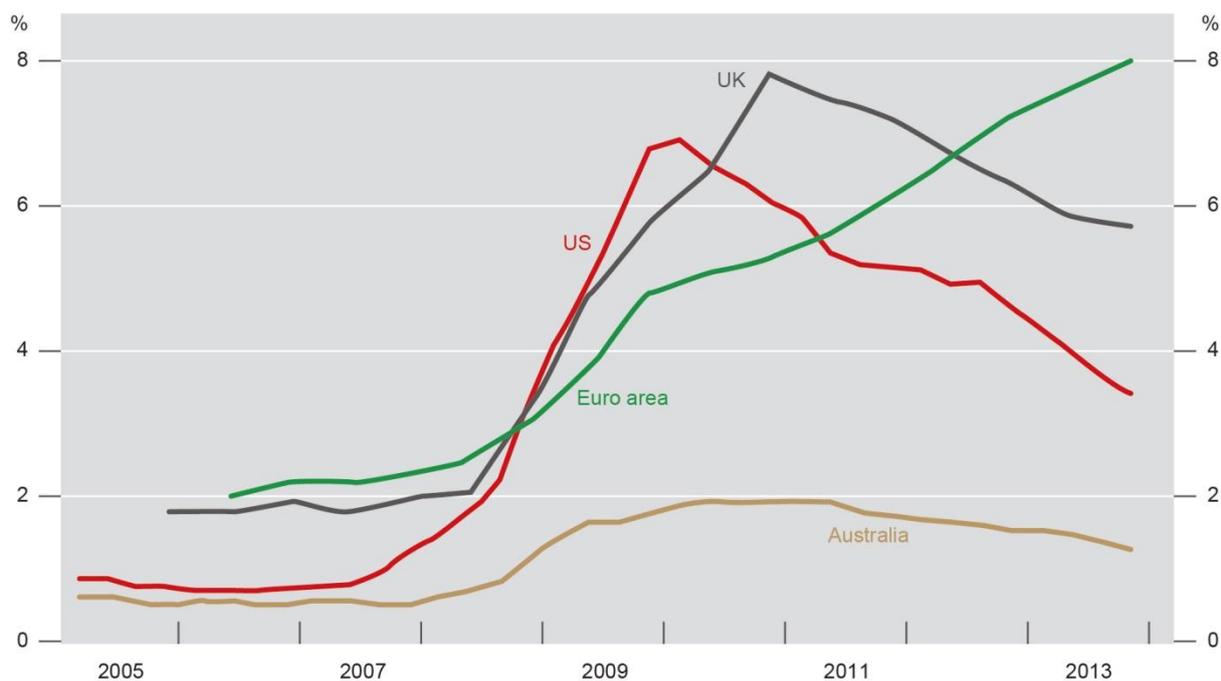
‘Financial stability risks posed by non-conforming lending remain limited so long as it remains a small share of total housing lending, consistent with the underlying narrow scope for prudent lending to households with blemished credit histories.’

The low exposure of Australia’s banks to this kind of lending is a significant factor in the overall proportion of non-performing loans, which is very low compared to other major economies (particularly following the GFC). This is illustrated in Figure 7.

⁸ RBA, DeBelle, Guy. ‘The State of the Mortgage Market,’ Address to the Mortgage Innovation Conference, 30 March 2010.

⁹ RBA, *Financial Stability Review*, September 2013, at p. 53

Figure 7. Large banks' non-performing loans as a share of total loans¹⁰



* Definitions of 'non-performing loans' differ across jurisdictions, sometimes including loans that are 90+ days past due but well secured and in the case of Australia small amounts of non-loan assets; includes 18 US banks, 41 euro area institutions, four UK banks, and four Australian banks; latest available data used where banks have not reported for December 2013
Sources: APRA; RBA; SNL Financial; banks' annual and interim reports

The factors above demonstrate that there is a low prevalence of 'non-conforming' loans in Australia which, in stark contrast to the US, has been a key contributor to the low level of non-performing loans and the stability of the housing finance market.

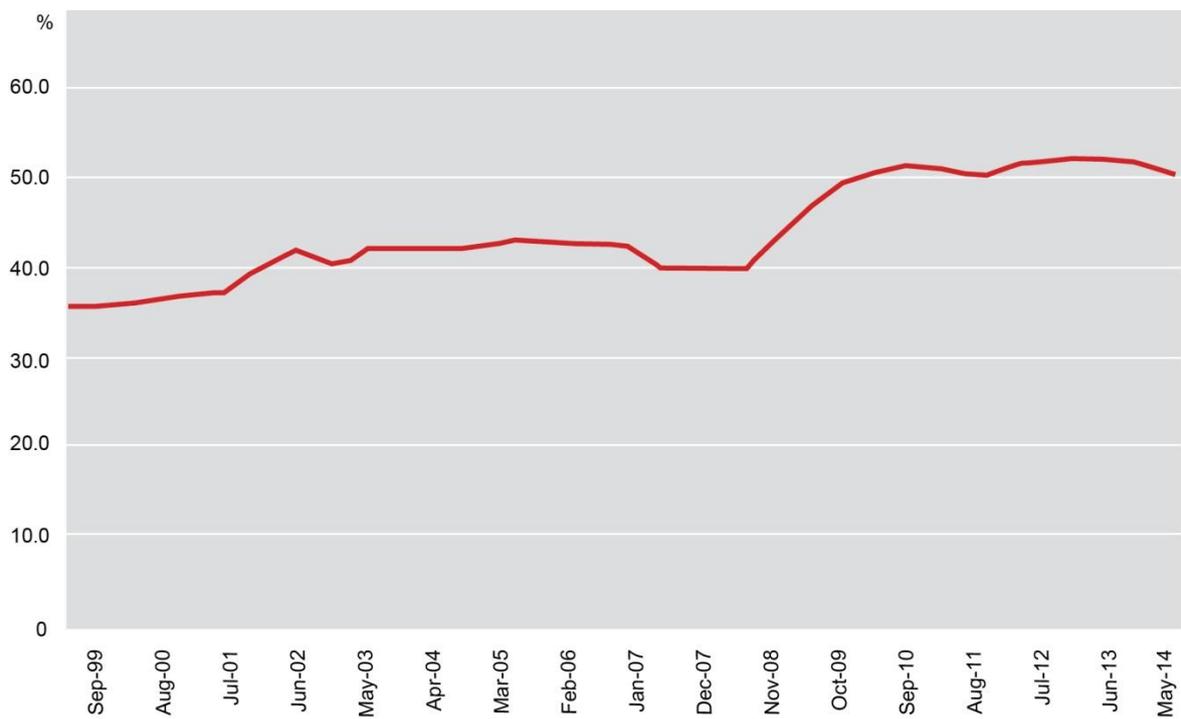
2.1.4 Indicators of systemic risk - supply-driven concentration of housing assets

The third indicator of systemic risk from housing finance would be a supply-driven 'overweighting' by banks of housing assets at the expense of other asset classes, particularly business lending.

In Westpac's experience, there is no evidence of this supply-driven 'crowding-out' occurring. Figure 8 shows that residential mortgages as a percentage of Westpac's total committed exposure only marginally increased between 1999 and the start of the GFC. The step-change in 2008 was due to Westpac's merger with St. George (a business with a higher portfolio focus on residential mortgages). Since then, the proportion of residential mortgages to total committed exposures has remained steady, and, in Westpac's case, does not support the assertion that there has been a supply-driven 'crowding out' of other forms of lending.

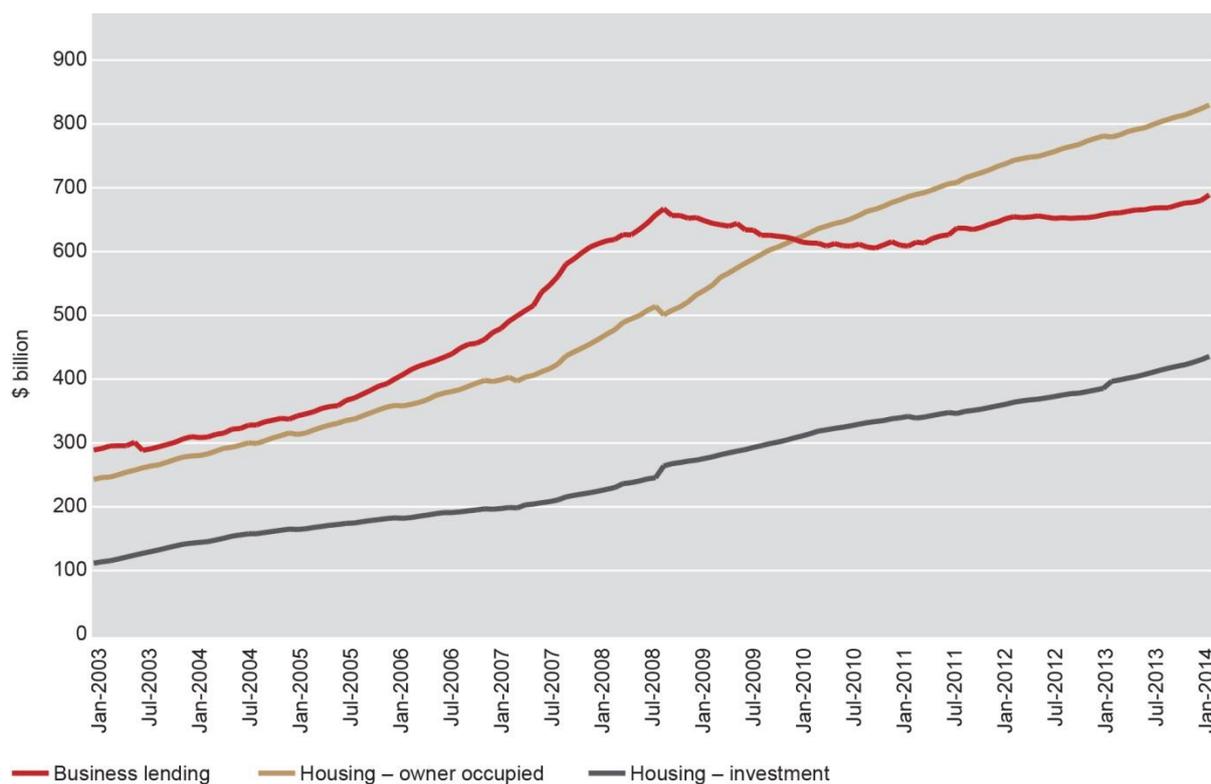
¹⁰ RBA, Edey, Malcolm, Address to the CFO Summit, Gold Coast, 16 March 2014.

Figure 8. Westpac residential mortgages as a percentage of total committed exposure



As can be seen from Figure 9, overall bank lending to businesses in Australia was growing in the years leading up to the GFC, and then decreased markedly following the crisis. In contrast, lending for housing – both owner-occupied and investor – did not experience a period of decline. Figure 9 also shows that bank lending to business has again started to grow.

Figure 9. Bank lending by sector (1993-2014)¹¹



Westpac believes that business deleveraging following the GFC, rather than ‘crowding out’ by housing finance, has been the significant factor behind the overall decline in bank lending to business in the period following the GFC.

Demand for business lending is influenced by a number of interrelated factors including economic growth, risk appetite for leverage, alternative sources of funding and the ability to re-value or write-off assets. These factors mean that, compared with households, demand for business lending is substantially driven by, and sensitive to, the economic environment. As these factors reach a turning point following the GFC, the contraction in demand for business lending should also unwind.

Further, businesses are also more easily able to adjust the level and source of their debt compared with households due to a number of factors, including:

- during an economic downturn, businesses are able to switch the mix of their funding between debt and equity, while simultaneously using a higher proportion of cash flow to retire debt more quickly;
- even during economic downturns, larger firms with recognised credit-standing will have access to non-intermediated funding through international bond markets and equity raising. These larger, more sophisticated firms will have even greater flexibility to reduce bank lending should they choose to; and

¹¹ RBA, Statistical Tables: <http://www.rba.gov.au/statistics/tables/index.html>
Table D5: Bank Lending Classified by Sector

- businesses fail at a higher rate than average during economic downturns, and lenders have to write debts off, reducing the stock of bank assets accordingly.

As a result of this flexibility, the stock of business credit will generally decline sharply during a recession or downturn, as observed during the early 1990s and the GFC period.

The market-based drivers of demand for business lending should naturally lead to an increase in bank lending to business in due course, and in Westpac's view, no regulatory intervention is appropriate to supplement the operation of these market forces.

The Inquiry should, however, be cognisant that increasing capital requirements on banks can disproportionately impact higher-risk lending, such as lending to SMEs. This is discussed further in Chapter 5.

2.2 Regulatory capital requirements for mortgage lending (2-11)

- No change to current arrangements
- Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation
- Increase minimum IRB risk weights
- Introduce a tiered system of standardised risk weights
- Lower standardised risk weights for mortgages
- Allow smaller ADIs to adopt IRB modelling for mortgages only

In addition to the factors discussed above, there are a number of other features contributing to the stability of Australia's housing finance market that can be contrasted to market features in other countries, such as the US. In those countries, the housing market substantially contributed to the financial crisis.

These stability factors were discussed in Westpac's Initial Submission. In summary, they include:

- Underwriting standards – for example, applying 'buffers' to interest rates to ensure that borrowers can continue to service loans even if borrowing rates rise;
- The use of securitisation in Australia for funding rather than risk transfer - In the US, securitisation had increased to over 60% of all mortgages by 2007. However, in contrast to Australia, the US securitisation market featured a number of incentives that contributed to a decline in underwriting standards. The underwriting standards of some originators became so compromised that some types of low-documentation loans became known as 'liars' loans';
- High rates of mortgage prepayment, driven by factors such as non-tax deductibility of interest payments on owner-occupied home loans;

- Full-recourse lending - most loans in Australia are ‘full-recourse,’ where the lender can recover any unpaid funds from other assets or future income. In contrast, most mortgages in the US are ‘non-recourse,’ meaning that the borrower has the option to ‘walk away’ from the loan. This means that situations of negative equity (e.g. due to falling house prices) will create an incentive for borrowers to walk away from the loan, known as ‘jingle mail’ – a reference to the borrower ‘mailing’ the keys of the property to the lender. This can create a vicious cycle in that delinquencies can result in additional downward pressure on house prices as lenders try to sell houses, adding to supply. In turn, this will increase the likelihood of more borrowers finding themselves with negative equity; and
- The rarity of significant ‘honeymoon’ period discounts on home loans (common in other countries) where deep interest rate discounts are followed by sharp step-ups in interest rates.

Australian banks also generally use conservative metrics for calculation of capital for mortgage lending. The issue of regulatory capital requirements, and the interaction of those requirements with competition in housing finance, is an issue that receives a level of focus in the Interim Report. It is, therefore, addressed in detail in this section.

2.2.1 Australian IRB mortgage risk weights

Regulatory capital requirements for lending portfolios should ensure banks have the capacity to absorb losses in the event of severe stress. By allowing banks to model their risks at a transactional level, the IRB capital approach creates incentives to more effectively analyse and manage lending risks, as well as other risks including interest rate risk and operational risk.

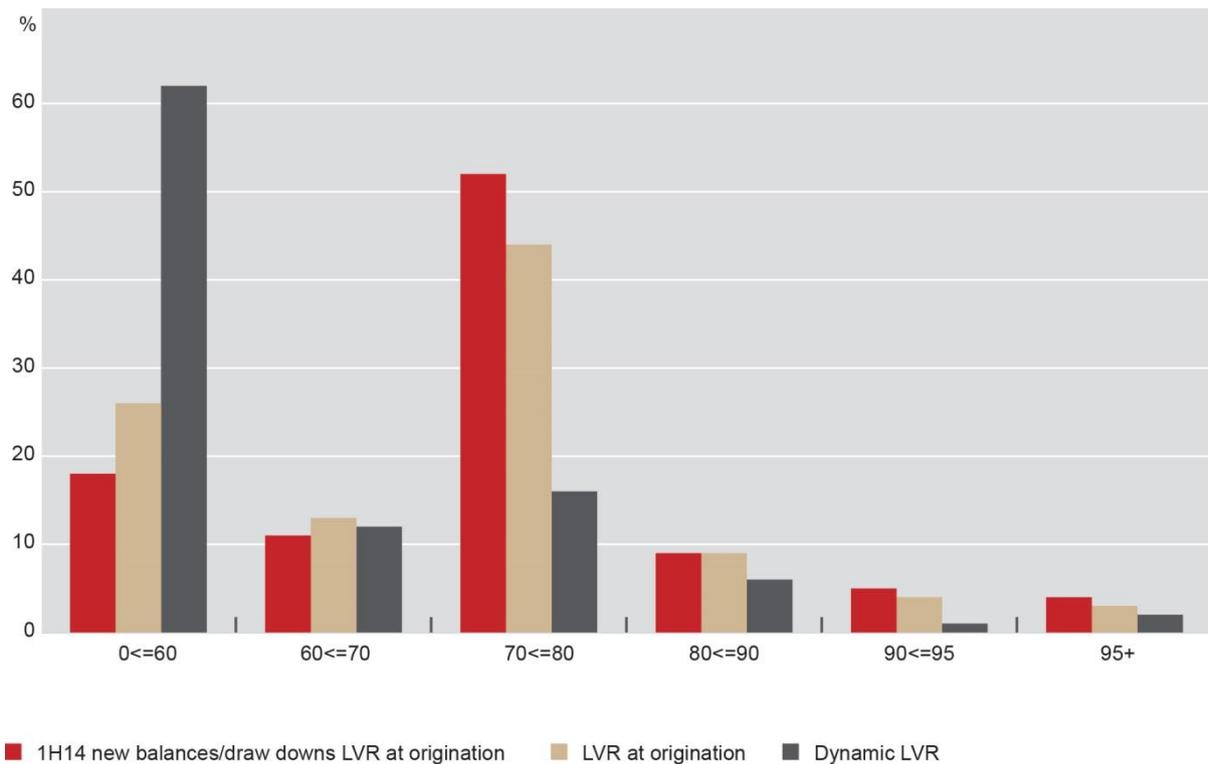
Risk weights for Australian mortgages are low relative to other lending portfolios. This is because the Australian mortgage portfolios of the major banks are well-diversified and low risk. The long run average default rate is less than 0.7% (fewer than 7 in 1000 defaulting), and average loss given default (LGD) is less than 5%.¹² This low LGD is attributable to mortgages being very well secured. Bank lenders have also maintained prudent underwriting standards with a very low proportion of low document mortgages. The long-standing practice of requiring lenders’ mortgage insurance (LMI) for lending over 80% Loan to Value Ratio (LVR) overlays the insurers’ underwriting standards and provides risk mitigation for bank portfolios.

The widespread availability of redraw mortgages and offset accounts, and the non-deductibility of interest on loans to owner-occupiers, are structural features of the Australian mortgage market that contribute to high rates of prepayment by borrowers.

This further reduces the risk of bank mortgage portfolios and is illustrated by Figure 10, which highlights that approximately 60% of the Westpac mortgage portfolio has a dynamic LVR (updated as residential house price indices change) of 60% or less. This creates a buffer of a 40% drop in house prices before these mortgages are in negative equity. As noted above, the mortgages greater than 80% are also generally covered by LMI.

¹² See page 49 of Westpac Pillar III. http://www.westpac.com.au/docs/pdf/aw/ic/Pillar_3_Report_Sep_2013_FINAL.pdf. It should be noted that results include data from New Zealand which has a higher loss experience than Australia.

Figure 10. Australian housing loan-to-value (LVR) ratios (%)

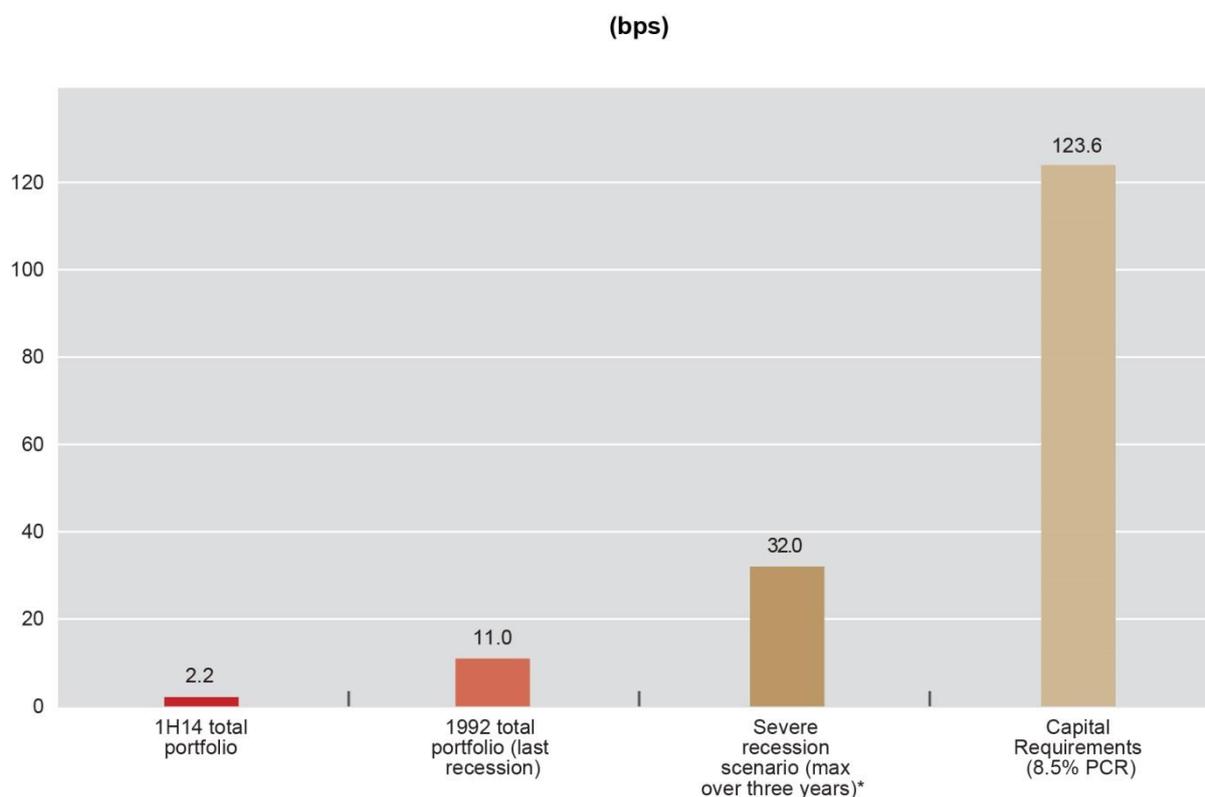


As a result, the well-diversified mortgage portfolios of the major banks typically experience annual losses in the range of 0.03% to 0.06%.¹³ Figure 11 shows the Westpac loss rates for the mortgage portfolio, highlighting a 0.022% loss rate for the first half of Westpac’s 2014 financial year. Investment property loans have a slightly higher loss rate with 0.031%, but remain very low. In the recession of the early 1990s, Westpac’s loss experience was low, only reaching 0.11%.¹⁴

¹³ Deloitte Report: http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Banking%20and%20Securities/Deloitte_Australian_Mortgage_Report_2013.pdf

¹⁴ Westpac March 2014 IDP http://www.westpac.com.au/docs/pdf/aw/ic/140509_Final_IDP_Presentation_1H14.pdf

Figure 11. Westpac loss rates for mortgage portfolio (PCR is Prudential Capital Ratio)¹⁵



In summary, the historical realised losses for Westpac’s mortgage portfolio have been very low. Nevertheless, Westpac recognises that history cannot be used as the sole indicator of the future. This reinforces the importance of stress testing. Westpac’s publicly available mortgage portfolio stress testing analysis demonstrates that while losses would substantially increase with a significant house price downturn in the Australian market, these losses are within expectations and Westpac’s loss absorption capabilities.¹⁶

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 (GDP) (down as much as -3.9% annual growth). The analysis includes how the LVR is impacted under the stress scenarios to ensure that the portfolio remains predominately fully secured, and that customers can meet their mortgage payment obligations through measuring and monitoring the debt serviceability of mortgages.

¹⁵ Severe recession scenario is based on an internal stress test scenario.

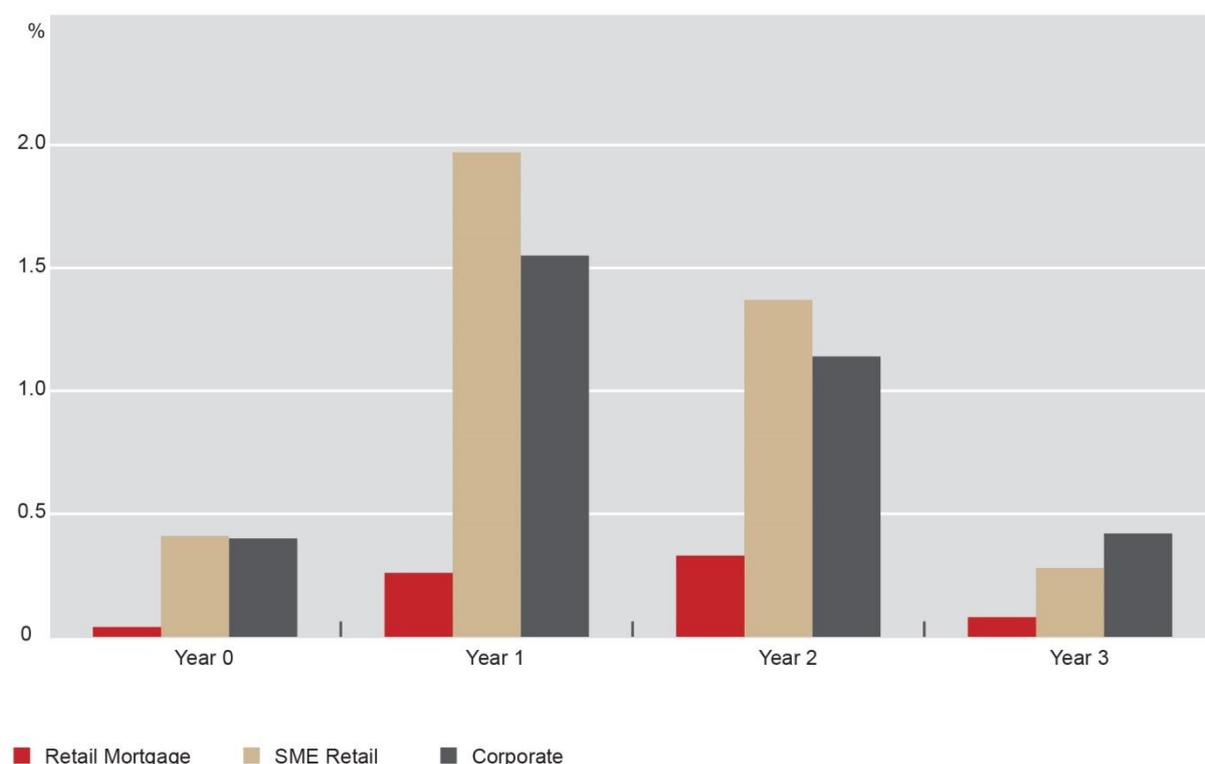
¹⁶ Westpac First Half 2014 Financial Result., p.77. <http://www.westpac.com.au/about-westpac/investor-centre/presentations-webcasts/2014/2014-interim-results/>

Figure 11 notes an expected loss rate of 0.32% in the mortgage portfolio under Westpac's internal benchmark severe recession scenario.¹⁷ In addition, a combination of other internal and externally derived scenarios are modelled which estimate annual mortgage portfolio losses in the range of 0.30-0.60%. As noted in APRA's submission to the Inquiry, the average capital requirement for IRB banks is 1.62%,¹⁸ sufficient to absorb losses well in excess of both historical experience and stress test outcomes.

Moreover, the stress testing shows that under a severe recession scenario the loss rates for the mortgage portfolio are lower than expectations from other products and portfolios. For example, the SME Retail portfolio can expect loss rates of 1.97% which are driven by the relatively high historic loss experience but also the susceptibility of small business to severe recessions.

Figure 12 shows the expected loss rates from a severe recession scenario across Westpac's residential mortgage portfolio, the large corporate portfolio and the small business (SME Retail) portfolio. The results highlight that the SME Retail and the corporate portfolios are much more exposed to a severe recession than the mortgage portfolio.

Figure 12 – Stress test loss rates for retail mortgage, SME retail and corporate (%)



IRB capital requirements for Australian portfolios provide an appropriate level of risk absorption capacity and incentivise ongoing risk analysis and risk management by IRB banks.

¹⁷ Westpac March 2014 Investor Discussion Pack

¹⁸ APRA calculates this figure using the average risk weight of 18% across IRB banks and, for simplicity, an assumed target capital ratio of 9% ($18\% \times 9\% = 1.62\%$).

APRA has imposed a portfolio level floor of 20% on the downturn LGD used for residential mortgages under advanced credit models (the LGD floor for residential mortgage exposures under the Basel Committee of Banking Supervision (BCBS) Basel III minimum requirements is 10%). Regulators in some jurisdictions have moved beyond LGD floors to impose overall floors on risk weights as a macro-prudential tool.

Westpac believes it is unnecessary for this macro-prudential tool to be employed in Australia where there is sufficient capital adequacy, and it would have the disadvantage of undermining risk sensitivity of capital measures. Combining macro-prudential objectives with IRB capital requirements distorts the transparency of capital adequacy measures across banks and markets. These distortions can be detrimental to the perception of Australia's relative strength, as they may overstate the risk of Australian banks relative to banks in other jurisdictions employing different approaches to the question of residential mortgage risk weights.

Consequently, Westpac does not support increases in minimum IRB risk weights or the introduction of overall risk weight floors above already conservative settings. APRA applies very strict standards to the approval of internal models and further challenges the resilience of those measures via stress testing. This more effectively ensures the integrity of the risk measures and resulting capital requirements without undermining risk sensitivity or the comparability of risk measures across different jurisdictions.

2.2.2 IRB versus standardised mortgage risk weights

APRA's submission to the Inquiry estimates average risk weights for IRB banks at 18% and for standardised banks at 39%. There are a number of offsetting factors not included in these figures. Standardised banks benefit from some concessions not available to IRB banks (e.g. lower weight of undrawn limits and no requirement for expected loss capital deductions), which effectively reduce the risk weight to approximately 34%.¹⁹ In addition, IRB banks are subject to capital requirements not applied to standardised banks (e.g. for interest rate risk in the banking book). They must maintain ongoing 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. As the Interim Report notes, *'this means that direct comparisons between IRB and standardised risk weights overstate any competitive advantage for IRB banks.'*²⁰

Nevertheless, even when taking these differences into account, capital requirements for standardised banks for mortgage lending remain higher than for IRB banks. Higher geographic concentration and other differences in risk profile justify some difference in capital requirements, although the Inquiry should also note that the extent of risk concentration will vary across Australian standardised ADIs. These considerations underpin APRA's observation in its Inquiry submission that *'there is a clear, risk-based logic in applying higher risk-weights on housing lending to standardised ADIs, which generally have more concentrated balance sheets.'*

¹⁹ 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 deduction (applied to IRB banks) adds 2% to IRB risk weights, which increases the effective concessions for standardised risk weights to 5%.

²⁰ FSI Interim Report, p. 2-9

2.2.3 Risk weight differences and competition

For both IRB and standardised banks, loss experience on mortgage portfolios is low and, as a result, capital requirements are low relative to other lending portfolios.

In its submission, APRA estimates that the impact of the difference in risk weights for IRB and standardised banks equates to approximately 23 basis points in terms of lending margin.²¹ As noted above, the direct comparison of risk weights overstates the true impact of the different capital approaches, which would more realistically be below 20 basis points. The mortgage lending market in Australia remains highly competitive and discount packages and campaign offers across the market regularly involve discounts well in excess of 20 basis points.

APRA has suggested that changes to capital requirements under Basel II have not been a key driver of changes in housing lending growth or market share in the post-GFC environment.

APRA notes in its submission to the Inquiry, that it *'did not view Basel II as a vehicle for changing the competitive landscape for ADIs but as an opportunity to align regulatory capital more closely with the risks that ADIs assume and how well those risks are managed.'*²²

2.2.4 Policy options

If there is a view that capital requirements overstate the risk of the mortgage portfolios of standardised banks, Westpac notes that there is a process underway at the BCBS level to consider risk weights. Westpac considers that BCBS efforts to reassess risk weights within the BCBS framework is the most appropriate avenue for considering any changes to standardised risk weights. However, as noted above, differences in risk profile, including due to geographic concentration, will limit the extent to which any potential changes in standardised risk weights would close the gap between standardised and IRB risk weights.

Westpac suggests that some form of targeted assistance for ADIs currently utilising the standardised model to attain existing IRB accreditation would be more appropriate. For example, consideration could be given to additional Government resourcing for APRA given the significant task to validate and oversee IRB accredited models. Retaining the requirement for standardised ADIs to make the necessary commitment to enhance their risk modelling capabilities would ensure the underlying principle of the advanced IRB and AMA approach is not diluted. These approaches create an incentive for banks to invest in risk analytics capability and, through greater risk sensitivity of capital requirements, continue to improve internal risk management practices.

²¹ APRA, Financial System Inquiry Submission, March 2014, p. 75

²² Ibid, at p. 74

Nevertheless, since the costs of achieving and maintaining advanced IRB accreditation are significant, a staged approach for banks transitioning to these advanced approaches could assist in the management of these costs without undermining the underlying principle. In particular, Westpac would support separation of the Advanced IRB approach for credit risk and the advanced measurement approaches for operational risk, allowing regional banks to progress to IRB accreditation for credit risk first. It is also reasonable that IRB accreditation can progress in stages for particular asset classes, although the principle of ultimately progressing improved risk management capability across the whole portfolio should be maintained.

Westpac agrees with the observation of the Interim Report that enhanced credit risk modelling capabilities are an essential feature of the financial system. The option of a staged transitioning to advanced approaches is therefore consistent with the principle of ensuring stability by improving risk management in the financial system, through an increased use of a risk sensitive approach.

2.2.5 Conclusion

Demand-driven factors, rather than regulatory capital requirements for mortgages, have been the primary drivers of the growth of housing finance in Australia. The evidence presented above demonstrates that the growth of this market is based on sound economic fundamentals, and is not 'crowding out' other forms of financing, such as unsecured lending to businesses.

Australian bank mortgage portfolios are diversified and low risk, and regulatory capital requirements are conservative. Stability in the housing market is also supported by the legal structure and operating practices of the Australian market. Overall, there is no compelling evidence to suggest that housing finance in Australia presents an undue systemic risk to the financial system and economy, such that further regulatory intervention would be required.

2.3 Vertically integrated business models

The Interim Report seeks further information regarding vertically integrated business models and their effects on competition. This is raised in two contexts:

- Vertical integration in the banking system, particularly in the context of mortgage brokers (at 2-21 of the Interim Report); and
- Vertical integration in the wealth management and superannuation sectors (at 2-115 of the Interim Report).

(2-21 of Interim Report)

- Is integration in the banking sector causing competition issues?
- Is vertical integration distorting the way in which mortgage brokers direct borrowers to lenders?
- If so, what would be the best way to limit the adverse impacts?

(2-115 of the Interim Report)

• Is the recent trend of greater vertical integration in the wealth management and superannuation sectors reducing competitive pressures and contributing to higher superannuation fees? Are there mechanisms to ensure the efficiency of vertical integration flows through to consumers?

These issues are both addressed in this section.

2.3.1 Bank competition and integration

As discussed in Chapter 2 of Westpac's Initial Submission, evidence indicates that the banking sector is competitive. This observation is supported in the Interim Report. Despite increased levels of integration by existing market participants, new competitors have also emerged, taking advantage of new methods of distribution in the digital environment.

There is no evidence that vertical integration is having any adverse effect on competition. Indeed, vertical integration has resulted in many efficiencies and benefits for customers. It has also deepened relationships with customers, meaning providers are highly motivated to provide a high-quality service offering through all of their interactions with a customer, or risk losing a customer relationship entirely.

Westpac operates in a market that encompasses a diverse range of competitors with different strategies, sizes and areas of focus, and a high degree of transparency. These factors negate any possibility for larger participants to hold or exert any market power or behave anti-competitively.

Westpac's competitive position across customer segments, products and geographies is determined by a variety of factors, including:

- the type of customer served;
- customer service quality and convenience;
- the effectiveness of, and access to, distribution channels;
- brand reputation and preference;
- the quality, range, innovation and pricing of products and services offered;
- technology solutions; and
- the talent and experience of its employees.²³

Vertical integration has not diminished the importance of Westpac considering these factors to enable it to provide a compelling offering to its customers in a highly competitive environment.

²³ Westpac Annual Report 2013, p 16.

2.3.2 Vertical integration in mortgage broking

In Westpac's view, there is no cogent evidence that vertical integration in home loans and mortgage broking has distorted competition and, to the contrary, there are a number of indicators showing strong price, service and innovation competition. These are outlined in this section. In addition, vertically integrated structures have generated pro-competitive outcomes for consumers.

Westpac supplies its home loans through direct distribution channels (e.g. retail branches, mobile lenders, online channels) and indirect distribution channels (e.g. mortgage brokers). Westpac is 'channel neutral' in respect of these methods of distribution as the availability of both is designed to enable customer choice. This is reflected in increased broker utilisation over time, and the split of Westpac home loans that are proprietary (57.5%) and broker-derived (42.5%).²⁴

a. Evidence of competition in mortgage broking

Westpac's Initial Submission described a highly competitive mortgage lending environment based on factors including contestability, broad product choice and pricing efficiency.²⁵ The mortgage broking industry has a number of features that demonstrate it is similarly vigorously competitive. These include the high degree of contestability between broking platforms, no or low barriers to entry or expansion, and increased innovation and diversification in the range of brokerage products and services offered to consumers.

The mortgage broking channel is very fragmented. There are a significant number of suppliers of mortgage broking services that competitively constrain any one mortgage broking platform. There are over 11,000 mortgage brokers in Australia and over 50 mortgage broker head groups and aggregators, including AFG, Plan, Fast, Choice, Connective and Vow.

Brokers require minimal capital requirements, since they can easily operate without premises or overheads, and as sole traders. This was recognised by the Australian Competition and Consumer Commission (ACCC) in its review of AHL/Wizard in 2006, stating that *'barriers to entry in the mortgage broking sector are sufficiently low so as to not significantly impede new entrants or existing competition from expanding.'*

Mortgage broking is also rapidly evolving and dynamic. In Westpac's experience, meeting changing customer behaviours is leading to material changes in distribution patterns. As at 30 March 2014, there has been a 17% increase in mobile mortgage managers, and 14% of all Westpac home loan applications are derived from this channel. Westpac branches now only account for 30% of home loan applications.²⁶

²⁴ Westpac 2014 Interim Presentation & Investor Discussion Pack, p 72.

²⁵ Westpac, Initial submission to the Financial System Inquiry, March 2014, pp 23-27.

²⁶ Westpac, 2014 Interim Financial Result Presentation, 14 May 2014, p 107.

Customers also have access to a range of information enabling them to conveniently and comparatively shop prices and product features through comparison websites such as canstar.com.au, iselect.com.au, and ratecity.com.au, amongst many others. This transparency further serves to check any possibility of distortion of competition through vertical integration.

b. No ability or incentive for mortgage brokers to distort competition

A vertically integrated bank-broker has no ability to distort competition. Even if a bank that owns a mortgage broker directed that broker to sell only that bank's loans, it would not have any anti-competitive effects because:

- other suppliers of home loans could sell through the significant range of alternative brokers, directly through branches or online (as acknowledged by the ACCC in its decision to clear the acquisition by the CBA of Aussie Home Loans in early 2013);²⁷
- as noted above, barriers to entry and expansion are low and so lenders could readily distribute any lost volume through alternative existing or new brokers, rapidly correcting any attempted 'distortion';
- customers can access home loans from a wide range of lenders providing loans through diverse channels, including directly through branches or online, and through a diverse range of brokers offering services through various communication and distribution means;
- other brokers can access a diverse range of lending products from a wide range of other lenders;
- if a vertically integrated bank/broker were to restrict access to third party lenders, the value proposition of the broker would be undermined – consumers would simply go elsewhere and mortgage brokers would likely defect to other brokers or aggregator platforms;
- whilst lenders have the ability to discontinue dealing with particular mortgage brokers and/or aggregators, they would have no incentive to do so as the removal of home loans from rival broker panels would merely reduce distribution of the lender's home loans and cede a share of home loans to rivals; and
- mortgage brokers are also restricted by law under the national credit protection legislation from acting against a client's best interests.

In terms of remuneration, the level of commission paid by Westpac to brokers is based on objective and neutral criteria associated with the level of service provided by brokers, such as where brokers refer good quality customers to Westpac.

Perceived concerns about whether vertical integration by foreclosing lenders' access to distribution channels and/or customer access to diverse products have been evaluated by the ACCC on numerous occasions and have been rejected.²⁸

²⁷ See, ACCC, Commonwealth Bank's proposed acquisition of Aussie Home Loans (21 March 2013); ACCC, National Australia Bank's proposed acquisition of Challenger's mortgage management business (7 October 2009); Aussie Home Loans' proposed acquisition of Wizard Home Loans (24 February 2009); ACCC, Westpac's proposed acquisition of RAMS Home Loans (19 November 2007).

²⁸ The ACCC assesses whether a merger would be likely to substantially lessen competition by taking into account a range of factors, including the nature and extent of vertical integration, set out in section 50 of the *Competition and Consumer Act 2010* (Cth).

2.3.3 Vertical integration in superannuation and wealth management

Wealth management providers are often vertically integrated, participating at multiple levels of the supply chain. There are varying degrees of vertical integration, depending on the scope of the provider's operations as well as the nature of the underlying products and services they offer.

Vertical integration is often said to exist where an institution both manufactures products and distributes them. In the case of wealth management, this distinction is overly simplified and fails to recognise the numerous underlying services that comprise wealth management.

Wealth management providers typically offer a variety of products and services. In some cases they 'manufacture' investment and insurance products, provide retail investment platforms and also operate networks of financial advisers.

Each one of these services comprises a number of underlying components. For example, at a minimum, a superannuation product consists of administration, funds management, financial advice and custodial services. Each of these services can be provided by an external provider or a related provider - in some cases both. This represents a form of vertical integration.

In the case of financial advice, there can also be misconceptions about the extent of actual integration due to poor understanding of underlying regulatory and ownership structures.

A recent study by Money Management shows that the seven largest wealth management companies (AMP, ANZ, CBA, IOOF, NAB, Suncorp and Westpac) have oversight of 72% of planners (around 10,850) across the top 100 advice networks surveyed.²⁹ Planning groups owned by ANZ, CBA, NAB and Westpac accounted for only 38% of planners (4,231) in the survey. These figures strongly contradict the often cited view that AMP together with ANZ, CBA, NAB and Westpac have around 80% of financial planners in the market.

This highlights the important nuances which must be understood before any conclusions about vertical integration are drawn.

Despite trends of greater vertical integration in wealth management and superannuation, there is no evidence that such integration is reducing competitive pressures and contributing to higher superannuation fees.

There is also no evidence that these providers are only offering their own financial products to their consumers. Instead, Australia's investment and platform market is largely built on an open-architecture approach. Platforms do not discriminate in favour of their own products, otherwise third party advisers will defect to other platforms given:

- the range of alternatives for product owners; and
- impact on value of the platform.

²⁹ Bank ownership of planners over-reported, 31 July, 2014: <http://www.moneymanagement.com.au>

Should product owners only supply via their own platforms, other platforms could readily turn to alternative, third party products, and the vertically-integrated product owners would lose distribution. At the same time, financial advisers would (and do) demand a wider product offering to meet the best interests of their clients. Not surprisingly then, all major platforms therefore comprise hundreds of underlying investment options.

In the case of Westpac, the number of underlying investment options manufactured by the Group (in-house funds) is in the clear minority when compared with those manufactured by third-parties and offered on Westpac-owned platforms.

For example, BT Wrap, the Group's largest platform, has 118 in-house managed funds out of a total of 756 managed funds – representing around 16% of the total.

When expressed in terms of the assets administered on the platform (rather than as a proportion of the number of investment options), the in-house options account for \$5.7 billion from a total \$35.7 billion – also representing around 16% of the total.

In addition, existing mechanisms comprehensively regulate any perceived conflicts of interest to ensure independence, including:

- duties owed by financial planners requiring them to act in the best interests of their clients;
- prohibitions under the Superannuation Industry (Supervision) Act 1993 relating to inducements from superannuation providers and other relevant increased MySuper trustee duties relevant to where trustees source investment management and insurance;
- the imposition of conflict priority rules under FoFA reforms; and
- Australian financial services (AFS) licence obligations which already include requirements to manage conflicts of interest as well as other 'supporting' obligations in respect of having adequate risk management and compliance arrangements in place and prohibitions against unconscionable conduct and misleading and deceptive conduct.

These legal obligations are embedded in the investment objectives and strategies of products issued by Westpac, in accordance with stringent governance protocols it has in place. Those protocols also ensure that the selection, monitoring and removal of Westpac investment products is guided by certain principles such as:

- focusing on the member or investor in all decisions; and
- monitoring performance to ensure the interests of members and investors are served at all times – including considerations such as performance relative to benchmark/objective and whether costs are reasonable.

Furthermore, the ACCC carefully assesses vertical integration issues before it decides to clear or oppose a vertically integrated acquisition/merger (under section 50 of the Competition and Consumer Act 2010). Other competition-related conduct prohibitions also apply in respect of refusals to supply, misuse of market power, predatory pricing and exclusive dealing.

Competitiveness of wealth management and superannuation

Westpac notes that the Inquiry does not have major concerns about horizontal consolidation in wealth management and superannuation, given the high degree of fragmentation in the market. Similarly, the Inquiry should not be concerned about vertical integration given this fragmentation, as well as the high degree of contestability, pricing competitiveness, and the large range of alternative funds available (including the ability to self-manage).

Non-price competition also arises from vertically integrated structures, resulting in significant consumer benefits. Vertical integration in wealth management has also provided greater opportunities to meet customer needs more efficiently. BT Super for Life provides a relevant example for how vertical integration in wealth management can provide better outcomes for consumers.

Case study: BT Super for Life

Developed in 2007, BT Super for Life was the first superannuation product integrated into online banking. This online integration would not have been possible in the absence of both parties – BT Financial Group (BTFG) and Westpac - being part of the same corporate group.

Today, BT Super for Life has over 260,000 active retail customers and manages \$4.7 billion on their behalf.

BT Super for Life has delivered a range of benefits to customers by virtue of being integrated with their banking.

Superannuation funds do not typically have a 'physical presence'. Accounts are therefore usually established through the workplace as a default or otherwise over the internet or via a financial adviser.

However, the integration of BT Super for Life with banking has allowed individuals to open their account at the same time they do their in-person banking in the branch. Super for Life accounts can also be opened in a matter of minutes in-branch, providing additional convenience compared to many alternative superannuation products.

The online integration has also raised the engagement levels of our customers with their super.

Consumer feedback consistently highlights that BT Super for Life's integration with internet banking is one of the product's most valued benefits. Consumers point to being able to monitor their contributions and earnings and not lose track of their super.

These benefits can be easily overlooked. Being able to monitor contributions in the same way they are able to monitor their banking account enables individuals to carefully track employer contributions, and notify their employer or the Australian Taxation Office (ATO) should contributions not be received on a timely basis or at all.

Additionally, with the significant amount of lost superannuation in the superannuation system, products like BT Super for Life drive much closer engagement between individuals and their superannuation – meaning they are much less likely to lose their super account in the future.

i. Contestability

A high degree of contestability is evident in the wide and diverse range of wealth management products provided by a large number of suppliers, including banks and non-banks. As the Inquiry indicates,³⁰ the industry is highly fragmented, with over 299 large APRA regulated funds and more than 530,000 smaller funds, predominantly SMSFs.

Westpac does not believe that vertical integration is adversely affecting competition in superannuation.

The top 10 superannuation funds account for approximately 54% of APRA regulated fund assets under management, while the top 20 account for approximately 73%. Further, as a proportion of total superannuation assets, the top 20 only account for approximately 46%.³¹ Superannuation funds managed by Westpac represent only approximately 4.3% of total superannuation assets.

Importantly, of the top 20 superannuation funds, seven are retail funds, seven are industry funds and six are public sector funds. This demonstrates that the sector is far from homogenous and that there is no dominant provider or sub-sector. This also illustrates the competitive dynamics in the market – a large number of providers with similar scale and varying ownership models and membership bases.

Almost all top 20 providers, including public sector providers, are vertically integrated in some way – whether because they provide their own administration services; employ their own advisers to provide financial advice to their members; or manage some proportion of their assets internally.

This should not be surprising. Wealth management services such as superannuation effectively comprise a bundle of services which when combined constitute a financial product or offering. It would arguably be impossible to manufacture a superannuation product in the absence of some level of vertical integration.

In the area of investment management, a key component of all superannuation products, the market is also extremely competitive – with an added competitive dynamic arising from large international participants contesting the Australian market.

Of the top 20 largest investment managers, ten are domestically owned, eight are global investment managers and two are Government owned. The top 20 investment managers account for approximately 68% of total assets under management.³² Of these, less than half are part of a wider vertically integrated institution that also provides retail financial services such as financial advice and superannuation. Vertically integrated providers only represent around one-third of the top 30.³³ This demonstrates that the market remains highly open and competitive, contested by a range of providers operating different business models.

In Westpac's case, investment managers within the Group collectively manage approximately 2.1% of total net superannuation assets in the system.

³⁰ FSI Interim Report, p 2-101.

³¹ (2014) Plan for Life & APRA superannuation statistics.

³² Rainmaker, June 2014

³³ Ibid

As a result, Westpac does not believe that vertical integration is having an adverse competitive impact on the market.

ii. Pricing competitiveness

There is no evidence to substantiate that vertically integrated providers are more expensive than non-vertically integrated providers.

In fact, some of the lowest cost MySuper products are provided by fully integrated providers and the lowest average cost MySuper segment is offered by retail funds.³⁴

iii. Large range of alternative funds available, plus ability to self-manage

While some consumers may not be sensitive to price, funds nevertheless compete aggressively, driven by 'league tables' and published metrics of funds under management.

To the extent a member is dissatisfied, they can choose to move funds among a very wide range of providers in a fragmented market, or to self-manage. In this context, vertical integration does not raise significant concerns as customers have the ability to switch if price or product choice is adversely affected and financial advisers have a duty to act in their clients' best interests.

SMSFs act as a significant constraint on larger funds. Members have the ability to self-manage if they consider fees/returns are unsatisfactory. Between the years ended 30 June 2009 and 30 June 2013, SMSF numbers grew from just under 400,000 to over 509,000, representing growth of over 27%.³⁵

While some disengaged members may not be price sensitive, this is not through lack of competition. As a result of the introduction of MySuper, additional trustee duties were introduced with a specific focus on fees and costs. Specifically, under section 29VN of the Superannuation Industry (Supervision) Act 1993, each MySuper trustee must promote the financial interests of the beneficiaries of the fund who hold the MySuper product, and in particular returns to those beneficiaries (after the deduction of fees, costs and taxes).

This is over and above the fiduciary duties owed by trustees to their members, providing further constraints on any attempt by vertically integrated or other superannuation funds to reduce price competition even if members are disengaged. Moreover, as noted above in relation to the BT Super for Life case study, Westpac has taken significant steps to address and reduce member disengagement.

In summary, there is no evidence that vertical integration is having any adverse effect on competition. Indeed, vertical integration has resulted in many efficiencies and benefits for consumers. It has also deepened relationships with customers, meaning providers are highly motivated to provide a high-quality service offering through all of their interactions with their customers, or risk losing such relationships entirely.

³⁴ Chant West research, March 2014

³⁵ ATO estimates, self-managed superannuation funds, 16 December 2013.

2.4 Other Policy Options

2.4.1 Residential mortgage-backed securities (2-17)

- No change to current arrangements
- Provide direct Government support to the RMBS market
- Allow RMBS to be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio.

Westpac does not believe direct Government support of the residential mortgage-backed securities (RMBS) market is necessary or appropriate. Options that would support the growth of the securitisation market are outlined in Section 4.14.1 of Westpac's Initial Submission.

Westpac supports the option of allowing RMBS to be treated as a high quality asset for the purpose of the liquidity coverage ratio. This would simply be recognition that RMBS are eligible securities for the RBA Committed Liquidity Facility and, therefore, RMBS are already part of ADIs' liquidity holdings. This may have the effect of increasing liquidity in the RMBS market.

2.4.2 Comprehensive credit reporting (2-18)

- No change to current arrangements
- Expand CCR by making it mandatory, adding new fields and/or extending it to SME lending

Westpac believes that natural competitive forces, rather than mandating, should shape comprehensive credit reporting (CCR) in Australia. This is consistent with overseas experience.

Mandatory CCR has not taken place in other established countries where CCR has been permissible, for example in the UK and US. Both countries achieved active contribution of data for all lending portfolios through natural competitive forces in the lending environment. This too would be appropriate in Australia, given the competitive nature of our banking system.

Mandating will impose significant technological and operational transition costs on all providers, regardless of the extent to which they rely on the additional CCR data - over and above the existing negative only data - for a credit decision. Mandatory CCR could result in lenders being required to undertake individual inquiries for all lending applications. This is not appropriate for all applications, particularly in cases where lenders have deep and long-standing relationships with customers.

2.4.3 Lenders' mortgage insurance (2-23)

- No change to current arrangements
- Decrease the risk weights for insured loans

Westpac supports the use of LMI as an appropriate means to manage risk in certain types of residential mortgage lending.

Loan insurance provides an additional layer of risk management and capital to support the origination of higher LVR loans. This, in turn, provides an increase in financial system stability in an economic downturn.

Under current arrangements, there is no capital incentive to insure loans for banks that use IRB risk weights. The regulatory capital to be allocated is the same whether or not a residential mortgage is covered by LMI. In particular, banks must apply a minimum LGD assumption of 20% even where LMI is in place. Moreover, there is no regulatory requirement that LMI should be in place if high LVR or non-standard loans are to attract low risk weights.

In contrast, smaller ADIs using standardised risk weights are able to assign lower risk weights to insured high LVR mortgages.

The continued availability of LMI provides benefits to the financial system – however regulatory settings currently provide a disincentive for further take up of loan insurance. Westpac believes there is merit in the Inquiry considering concessional capital treatment across residential lending – irrespective of IRB or standardised treatment – for the use of LMI on residential mortgage lending.

2.4.4 Payments sector (2-32)

- No change to current arrangements
- Lower interchange fee caps or ban interchange fees
- Expand interchange fee caps to include payments of similar economic substance
- Remove interchange fee caps
- Cap merchant service fees or cap differences in interchange service fees between small and large merchants
- Require acquirers to enable merchants to choose which scheme to route transactions through
- Allow payment schemes to reintroduce 'no surcharge' rules or broaden the ban on 'no surcharge' rules to all payment systems
- Enforce reasonable cost recovery in customer surcharging
- Provide merchants and customers with real-time pricing information regarding interchange fees and merchant service fees

Westpac believes that a compelling case has not been made for significant new regulatory changes to the current operation of the payments system. It is clear from the evidence presented to the Inquiry that not only is the issue controversial with competing arguments, but that no clear consensus has emerged on the issue.

Merchants see a strong business case in arguing for lower interchange fees,³⁶ but support surcharging, whilst Card schemes argue against interchange regulation³⁷ but favour a return of no-surcharging rules.

Westpac argued to the 2008 Review of Card Payment Systems Reforms that following the deregulation of surcharging controls, RBA's initial justification for interchange intervention had grown weaker. Given the increasingly fragmented and competitive market since that time (e.g. the introduction of new payments players such as PayPal), Westpac believes the justification for interchange fees is weaker now than it was in 2008.

In 2008 Westpac argued that once merchants were given the right to surcharge, the economic argument for Interchange Fee regulation was weak. These arguments remain valid:

*'We support the move towards deregulation of interchange and the freedom for competition to determine interchange levels... the current competitive environment does not support a strong case for ongoing interchange regulation... The main basis for our... conclusion is that the structural impediments to competition identified in the Paper do not appear to survive in a strong form when applied to the payments market. While the 'prisoner's dilemma' theory outlined in the Paper may have helped describe the market prior to the abolition of the No-Surcharge Rule (NSR) and introduction of surcharging, this does not appear to be a good description of the merchant acquiring market today.'*³⁸

Further, Westpac agrees with the general aversion that the Inquiry has exhibited towards price regulation, noting:

*'The Inquiry believes independent monetary policy, prudential supervision and conduct regulation remain the preferred approach over direct Government control of prices and quantities in the financial system. Competition remains the cornerstone of a well-functioning financial system. It is vital in driving efficient outcomes for price, efficiency, quality and innovation.'*³⁹

On this basis, Westpac does not agree with the Inquiry's observation that *'regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes.'*⁴⁰ Indeed, the introduction of new regulation should always be wary of unintended consequences. The drive for regulation often drives calls for further regulation. For example, the regulation of Visa and MasterCard interchange fees is now driving consideration of regulation of other near competitors. Such unintended consequences of regulatory intervention continue to distort markets and divert attention towards regulatory arbitrage opportunities (e.g. shift of focus towards non-regulated business).

³⁶ Federal Court of Australia (2005), final judgment in *Australian Retailers Association v Reserve Bank of Australia FCA 1707*, Melbourne.

³⁷ Federal Court of Australia (2003), final judgment in *Visa International Service Association v Reserve Bank of Australia N 973 of 2002 and MasterCard International Incorporated v Reserve Bank of Australia N 987 of 2002*, Sydney.

³⁸ <http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-pre-conclusions/wbc-30062008.pdf>

³⁹ FSI Interim Report, p1-1

⁴⁰ FSI Interim Report, p 2-27

For instance, Westpac does not support requiring acquirers to offer merchants transaction routing, as cardholders should be able to select their payment method based upon product features that accrue (e.g. travel insurance, payment protection, points, fraud protection) and brand preference. Further, different transaction routing can result in the use of different accounts without the cardholder's knowledge. Customers should have the right to choose a payment type and account. Merchants should have the right to choose whether they accept it.

Likewise, real-time pricing information would be extremely complex to implement and somewhat impractical at the check-out. Additionally, a card holder's value equation is not just based on price – it includes brand values and product features.

Further, Westpac would note that increased regulatory change often comes with significant executional costs and can create ongoing investment risk, with greater reticence for payment system participants to invest for the longer term.

Rather than new regulation, Westpac supports the existing regulatory structure where the Payments System Board (PSB) administers the Payment Systems Regulation Act independently of Government. The PSB is able to seek competition-based outcomes over further regulatory intervention, for example, through their support of increased interaction with the payments industry through the Australian Payments Council.

Chapter 3 - Funding

Westpac Key Issues and Insights

Banks and funding credit growth

- Westpac reiterates its belief that ensuring the financial system has the capacity to support optimal growth in all economic conditions should be the most important objective of the Inquiry.
- Westpac believes that the Inquiry needs to give greater weight to the issue of bank funding of credit growth, particularly the potential impact of a higher credit demand environment on the capacity of Australian banks to supply that credit.
- While the system will necessarily adjust to equilibrium where credit demand equals credit supply, that adjustment is likely to lead to higher prices, which will negatively impact the substantial number of borrowers that rely on bank credit.
- Ensuring that the banking system has appropriate access to high quality funding sources is essential for the customers that banks support, particularly individual households and small and medium businesses.
- Measures to equalise the tax treatment of deposits and other competing savings options would be effective in enhancing the high-quality funding available to the banking system. Encouraging the investment of superannuation into bank deposits and fixed income securities would support this goal.

Other funding options

- There are a number of other opportunities for increasing the existing funding base for the financial system such as broadening the corporate bond market and the further growth of securitisation.
- Reducing information asymmetry would ensure banks are able to support SMEs in their desire for finance, and is therefore an important consideration for the Inquiry. Westpac supports the proposed option of increased lender access to government and regulator sources of information, in particular full details of tax returns and real time access to business activity statements.
- The development of both deeper and more efficient corporate bond and social impact investment markets will also assist in providing the Australian economy and its participants with more diversified pools of funding.

Chapter 3 – Funding

Westpac's response to the Interim Report's observations regarding Funding focuses on the banking system and its capacity to fund credit growth in various economic conditions.

This Chapter also addresses other policy options raised by the Interim Report's Funding chapter.

3.1 The banking system and funding credit growth (2-79)

Issues regarding bank funding of credit growth are extensively discussed in Westpac's Initial Submission to the Inquiry. Ensuring that the financial system has the capacity to support *optimal* growth in all economic conditions is vital. Westpac believes that banking is the most efficient and resilient medium to provide broad-based credit provision to Australian borrowers. The arguments supporting this view are presented in Chapter 4 of Westpac's Initial Submission.

Therefore, ensuring that the banking system has appropriate access to high quality funding sources is vital not just for banks but, most importantly, for the customers that banks support. For this reason, Westpac wishes to respond to the observations made regarding bank funding and credit growth in the Interim Report, particularly the observation that:

'In the view of the Inquiry, high-quality projects and viable enterprises would still be able to obtain funding through other channels if insufficient credit was available. But it acknowledges entities that are more reliant on loans, such as small business, would have some difficulty accessing funding.'⁴¹

3.1.1 The importance of supporting optimal economic growth

This observation relates to a period of higher credit demand. In this scenario, the ability of Australian banks to increase their borrowing capacity in offshore wholesale markets is uncertain. The drivers of this uncertainty are discussed in Westpac's Initial Submission. They include the relative attractiveness of Australian banks to investors and global economic conditions. Banks' prudent risk appetite would also necessarily limit the utilisation of offshore wholesale funding.

Generally, Westpac agrees that many (but not necessarily all) high-quality projects and viable enterprises would still be able to obtain funding in this higher-credit demand scenario. Moreover, it is clear that credit demand will always be equal to credit supply, and that the funding of the system will always operate in equilibrium.

⁴¹ FSI Interim Report, Chapter 3, at p 2-79

The critical issue, however, is the process of adjustment to that equilibrium – does it result in optimal economic growth? Answering this question requires consideration of how various sectors of the economy would be affected through this adjustment. And, in Westpac’s view, it is likely that the substantial number of households and businesses reliant on bank funding would likely face higher lending rates through a purely market-based adjustment. Further, affected borrowers may be forced to seek credit through unregulated, ‘shadow’ sectors, which could increase system risk in the financial system.

The most efficient way to ensure the financial system has the capacity to best support optimal growth – and to minimise the impact on households and businesses of constrained credit supply during periods of higher credit demand – is to increase the source of high quality funding to the banking system.

3.1.2 The process of adjustment

In the higher credit growth scenario, increased demand for funding is likely to be satisfied in part by greater corporate bond issuance and, potentially, greater equity investment from offshore. However, banks will also seek to satisfy this demand from their customers. To do so, banks will require more deposits to fund asset growth to remain within regulatory limits and risk appetite. Increased demand for deposits will lead to higher deposit rates, which is likely to be offset at least partially by an increase in lending rates for customers.

Financially flexible borrowers that can easily switch between various sources of debt and equity funding are likely to benefit from this process of adjustment. Many of these borrowers may, indeed, be able to access non-bank intermediated funding for high-quality projects. They possess the recognised credit-standing and sophistication for timely access to capital markets.

Parties seeking to attract overseas capital would also likely benefit from this scenario, similar to the period between 2008 to 2009 where there was increased foreign equity investment in Australia of \$141 billion.⁴²

However, customers that primarily rely on bank credit are likely to face higher lending costs. The quantum of customers that rely on bank credit is very large – it is a significant component of the nation’s demand for finance. For example, loans are the funding source for 94% of households,⁴³ and 90% of total loans in the economy are made by banks.⁴⁴

We also know that small businesses mainly obtain their debt funding from banks and other financial institutions, as it is difficult and costly for them to raise funds directly from debt capital markets.⁴⁵ The significant number of businesses reliant on bank funding is illustrated by the number of Westpac business customers that have facilities under \$100 million (a fair proxy for businesses that are likely to find access to market-based funding challenging). There are approximately 420,000 of those business customers, with a total of approximately \$125 billion of loans, which make up approximately 92% of Westpac’s total business loans.⁴⁶

⁴² Westpac analysis.

⁴³ Australian National Accounts; Financial Accounts, September 2013 5232.0.

⁴⁴ Westpac analysis.

⁴⁵ RBA, Submission to the Financial System Inquiry, March 2014, p.124

⁴⁶ Current at June 2014.

This demonstrates the very significant quantum of customers potentially affected through a purely market-based adjustment of credit supply in a higher credit demand scenario.

3.1.3 Long-term funding solutions

Westpac agrees with the Inquiry's observation that:

*'A more stable funding composition enhances the ability of ADIs to fund long-term loans. The Inquiry recognises the need for some adjustments, particularly to tax, to ensure a more efficient allocation of funding in the economy.'*⁴⁷

Measures to equalise the tax treatment of bank deposits and other competing savings options would be effective in enhancing the high-quality funding available to the banking system. Encouraging the investment of superannuation into bank deposits and fixed income securities would also support this goal.

In addition to supporting a more stable ADI funding composition, Westpac urges the Inquiry to also consider these measures in the context of ensuring that the financial system has the capacity to support optimal growth in all economic environments. This is important for the millions of customers that rely on banks to fund their economic activities.

3.2 Other Policy Options

3.2.1 Housing and household leverage (2-57)

The Inquiry seeks further information on the following area:
What measures can be taken to mitigate the effects of developments in the housing market on the financial system and the economy? How might these measures be implemented and what practical issues would need to be considered?

This information is provided in Chapter 2 of this submission, Competition.

3.2.2 Small and medium-enterprises (2-68)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Facilitate development of an SME finance database to reduce information asymmetries between lenders and borrowers.

The Interim Report notes that *'information asymmetries are the most significant structural factor contributing to the higher cost and lower availability of credit for SMEs.'*⁴⁸

Westpac believes the Inquiry's focus on measures to improve the level of information available to credit providers to assess the creditworthiness of SME borrowers is appropriate.

⁴⁷ FSI Interim Report, at p.2-79

⁴⁸ FSI Interim Report, at p.2-63

a. Key benefits of reducing information asymmetry

The key benefit of access to any additional information (including MYOB accounting software outputs, ATO data and positive credit reporting) will be process efficiency in the origination process. This includes the ability to assess the probability of default (PD) more accurately, and improvements to the speed of credit decisions.

Where possible, Westpac applies an automated credit evaluation approach for SME retail lending applications, rather than individual manual assessment. This involves the use of a data-driven decision engine, and automated rules to maximise the frequency with which a loan can be approved without having to be reviewed by a credit officer. The principal benefit of this approach for the end customer is the speed with which an answer can be provided.

The requirement to provide company financials can be an onerous and time-consuming activity for an applicant. Often, the information supplied in the first instance will be incomplete or missing certain mandatory elements. Allowing another mechanism for lenders to have access to the information source (e.g. the ATO) would ensure that the required information would be received promptly and completely. This would undoubtedly provide further improvements to the process, providing more customers with faster decisions.

The Interim Report questions whether a reduction in information asymmetry could increase lending to SMEs and lead to more variation in pricing.

An increase in the range and quality of automated data sources allows lenders the opportunity to better classify risk. This increased opportunity could therefore lead to more variation in risk-based pricing, and the potential for increased lending to currently under-served segments, (unsecured, start-ups). However, it may take a period of time for lenders to accumulate sufficient data to build such strategies.

It is also important to note that collateral is not simply a proxy for information. Therefore, even with reduced information asymmetry, secured lending will be required in circumstances due to risk profile. Collateral is also used to ensure there is an alignment of interests between the business and lender.

Westpac will also continue to utilise a portfolio approach which averages both risk and pricing across the SME book. This provides a benefit to customers who may lack complete information, in contrast to transactional based pricing and risk grading. Nevertheless, increased information can assist in greater personalisation of pricing within this portfolio approach.

b. Options to reduce information asymmetry

Westpac supports the proposed option of increased lender access to government and regulator sources of information, in particular full details of tax returns and real time access to business activity statements. However, Westpac believes that a mechanism for customers to provide lenders direct access to government and regulator sources of information would be preferable to a third-party, commercial database. This could avoid barriers such as a lenders' reluctance to share commercial-in-confidence information and align with existing privacy legislation.

The Inquiry seeks further information on the following areas:

- Could the use of certain loan covenants be reduced, while still providing SMEs with adequate access to finance and lenders with appropriate protection?
- What are the prospects for a market for securitised SME loans developing?

a. Loan covenants and internal processes

The Interim Report questions whether the application of non-monetary clauses could be more transparent and whether their application in SME facilities is unfair. Westpac SME facilities do not regularly include ongoing covenants. Where there is non-financial covenant failure, it is unlikely this would trigger the refinancing of the facility. Rather, a risk-grade review would be triggered, which may lead to a review of the business financials. The breach of a non-financial covenant may therefore act as an early warning sign.

The non-application of these covenants contributes to an information asymmetry to the detriment of the lender, as non-financial covenants provide transparent information to the lender about how a business is performing on an ongoing basis. It is unlikely that the mechanisms proposed in the Interim Report would replace the availability of this type of information to lenders. Westpac considers that other sector-specific conditions such as environmental reports or evidence of appropriate licenses/ permits are appropriate.

Westpac does not believe that, even where these clauses are applied, that they are applied in a non-transparent manner. Nevertheless, there is an opportunity for the Government to review the current legislative barriers to simplified, plain English disclosure. This is discussed in Chapter 6. Further, Westpac is currently undertaking a review of business lending documentation, including facility offers, securities, covenants and ancillary documents, to implement a reduced number of more simplified documents.

The Interim Report also notes that ADIs could make internal process improvements to avoid overly cumbersome application processes.

Westpac recognises that credit application processes can impact demand. For that reason, Westpac is investing in simplifying and streamlining business lending origination platforms and processes. For example, Westpac is developing 'Drive On-Line,' an on-line point of sale decision and documentation system for equipment finance which can provide SME customers with same day funding of finance. Further initiatives in this regard were discussed in detail in Chapter 5 of Westpac's Initial Submission.

b. Market for securitised SME loans

As noted in Westpac's Initial Submission, overseas jurisdictions have seen a marked decline in SME lending. Deleveraging of balance sheets to increase holdings of relevant capital components has been a key mechanism for overseas banks to comply with international capital regulations. One strategy to address regulatory capital constraints has been the development of structured finance transactions by European banks. The European Central Bank has invested in senior tranches, with originating banks holding the junior (equity) tranches.

There are no structural impediments to the development of a market for securitised SME loans developing in Australia, provided a reasonably homogenous set of product principles could be developed. This would require the ability to establish highly granular eligibility and performance metrics. This structured finance could facilitate SME lending.

Nevertheless, as noted above, the drivers that have led to the development of this securitisation market overseas are not relevant here.

3.2.3 Impact investment and social impact bonds (2-75)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Provide guidance to superannuation and philanthropic trustees on impact investment.
- Classify a private ancillary fund as a sophisticated or professional investor for the purposes of the exemptions from the prospectus regime if the sponsor of the fund meets either of these thresholds.
- Simplify and streamline disclosure requirements associated with social impact bonds.
- Undertake a more active role in expanding impact investment, such as providing risk capital and establishing social investment banks.

Westpac believes there are opportunities to promote the development of a deeper and more efficient social impact investment market.

The fiduciary duty owed by trustees has, naturally, impeded investment by some superannuation and philanthropic trusts in social impact investments. That said, there is no current impediment to funds being established solely to invest in social enterprise, with a view to maximising returns within the class of social investments. Although there is no downside to government providing guidance to trustees, this is unlikely to materially increase the value of social impact investments.

Given the complexity of some social impact investments, such as social benefit bonds, Westpac does not advocate a stream-lining of prospectus preparation or reduction in related disclosure. Until this asset class becomes more established, Westpac believes it is suitable only for sophisticated investors. It would assist the social impact investment market for the Australian Securities and Investments Commission (ASIC) to confirm when, in the context of social investment, a trust or SMSF would be considered a sophisticated investor.

Westpac believes there is a role for government in assisting the development of social impact investment markets through making capital available, in particular as an 'equity-style/first loss' investor. This would be similar to the Federal Government's role in Social Ventures Australia's Social Impact Fund. Particularly in the domain of social benefit bonds, government has substantially more information on the likely success of a social program compared with an ordinary investor. Government willingness to invest capital at a higher risk than is being sought from investors provides reassurance, and ensures greater alignment.

3.2.4 Domestic demand for corporate bonds (2-91)

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Allow listed issuers (already subject to continuous disclosure requirements) to issue 'vanilla' bonds directly to retail investors without the need for a prospectus.
- Review the size and scale of corporate 'vanilla' bond offerings that can be made without a prospectus where the offering is limited to 20 people in 12 months up to a value of \$2 million, or for offers of up to \$10 million with an offer information statement

Westpac supports allowing listed issuers to issue 'vanilla' bonds directly to retail investors without the need for a prospectus. If the listed market is to compete with alternate funding options, listed companies must be able to move quickly by way of a streamlined process which minimises documentary requirements for issuers that are already subject to disclosure requirements.

The current prospectus based approach (albeit simplified) and the associated liability regime will not encourage existing capital markets borrowers to issue securities directly to retail investors. Furthermore, the two-part prospectus regime will provide marginal value to the vast majority of corporate issuers as their issuance cycle is typically greater than every three years.

An alternative, 'no prospectus' approach, may take the form of an 'Investor Information Statement' and a specific term sheet detailing the key commercial terms for the proposed security. This approach has already been utilised by the Australian Office of Financial Management for the offer of exchange traded treasury bonds, and a variation of which is being introduced in New Zealand by the Financial Markets Authority (pursuant to the FMCA 2013).

Westpac supports an approach that facilitates 'transmutation' of wholesale over-the-counter (OTC) issuance to retail investors via the listing of Chess Depository Interests (CDIs) on the Australian Stock Exchange (ASX). This approach establishes a robust price discovery of the underlying securities via participation of wholesale and retail investors, and maximises ongoing liquidity. Securities (vanilla bonds) made available to retail investors via this approach should require minimal additional disclosure.

The Inquiry seeks further information on the following areas:

- As a greater share of the population enters retirement, would the demand for fixed income products increase in the absence of regulation or other incentives?
- Would the development of annuity-style retirement income investment products encourage the growth of fixed income markets?
- Could enhanced transparency of transactions improve liquidity in the over-the-counter Australian corporate bond market, including its attractiveness to retail investors? What commercial or regulatory impediments are there to the potential development of improved transparency in the over-the-counter corporate bond market?
- Could alternative credit ratings schemes develop in Australia and would this help improve the appetite for bonds, particularly those of growing medium-sized enterprises? Could alternative standards of creditworthiness develop in Australia? What are the barriers to such developments?

A greater share of the population entering retirement is likely to impact the demand for fixed income products, but a number of other features of the financial system are also relevant. For example, existing tax settings tend to favour an allocation of savings to equities and property compared with fixed income investments.

The under-developed market for specialised retirement stage products, and the ability to switch superannuation providers, also leads to a greater emphasis on shorter dated liquid investments. This too affects demand for fixed income products.

As asset managers seek duration to match the underlying liability obligations pursuant to lifetime annuities, aged care annuities and longer-term fixed date annuities, this should have a positive impact on demand for longer duration fixed income products and competitiveness of the domestic market versus offshore (on average longer duration demand).

Westpac believes that enhanced transparency of transactions would improve liquidity in the OTC Australian corporate bond market.

In addition, greater transparency will drive convergence between a wholesale OTC market and a retail market (via transmutation of listed Chess Depository Interests (CDIs) on the ASX). ASX quotation will provide enhanced price discovery and transparency as well as other more palatable features for retail investors and intermediaries such as smaller denominations, greater divisibility and investment and super wrap platform availability.

Chapter 4 - Superannuation

Westpac Key Issues and Insights

Superannuation efficiency and stability

- Westpac supports the Inquiry's focus on the superannuation system as a vital aspect of its review of Australia's financial system. The growth in superannuation is one of the most important developments in the financial system since the Wallis Inquiry, and has broad implications for the economy and the welfare of all Australians.
- Westpac supports the creation of an independent statutory advisory body to provide oversight and policy advice to government on superannuation.
- Recent and ongoing reforms such as MySuper, SuperStream and FoFA are having a substantial impact on the Australian superannuation landscape. These legislative reforms have come with a substantial cost to superannuation providers and will take several years before all of the potential benefits are realised.
- There is evidence MySuper has already placed downward fee pressure on superannuation providers and Westpac believes this will continue as the reforms fully take effect.
- Westpac also believes that the realisation of some MySuper benefits could be accelerated through both the removal of anti-competitive default fund provisions, and through the creation of a member centric product rationalisation framework that can assist to modernise the sector.
- Westpac rejects much of the analysis and conclusions of the recent Grattan Institute report into superannuation fees and competition. The report fails to make an appropriate comparison with similar international defined contribution schemes, and ignores the competitive impact MySuper is already having and will have over time.
- Consideration of any alternative model should be deferred until at least 2020 on the basis the current reforms will not be fully implemented until mid-2017.

SMSFs

- The current level of oversight and analysis of the systemic implications of the SMSF sector is insufficient given its size and continued growth. Westpac continues to encourage the Inquiry to consider ways that these matters can be addressed.
- Westpac also believes that suitability remains the most important policy consideration in relation to SMSFs. Given the different levels of consumer protection across APRA regulated funds and SMSFs, Westpac supports the need for a clearer requirement before the establishment of an SMSF can be recommended.

Chapter 4 – Superannuation

Westpac supports the Inquiry's focus on the superannuation system as a vital aspect of its review of Australia's financial system. The growth in superannuation is one of the most important developments in the financial system since the Wallis Inquiry, and has broad implications for the economy and the welfare of all Australians.

Australia's superannuation system is performing well. Australia now has the fourth-largest pension market in the world, and the superannuation system is ranked equal second globally on adequacy, sustainability and integrity measures.⁴⁹

Since the start of compulsory superannuation 22 years ago, the annualised mean return was 8% per annum, or 5.4% above inflation.⁵⁰ This is calculated net of investment fees and tax and well above the typical MySuper return objective of CPI +3.5%. There is therefore strong evidence that Australia's superannuation system is working effectively, and that a high threshold should be set for further changes to policy settings.

4.1 Superannuation settings (2-118)

Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.

4.1.1 Intergenerational / bipartisan policy stability is needed in superannuation settings

Recent and ongoing reforms are having a substantial impact on the Australian superannuation landscape. FoFA, MySuper (including expanded APRA prudential standards and data reporting requirements) and SuperStream represent a substantial investment by government and business into the quality and efficiency of the Australian superannuation system.

To a large extent these reforms are yet to be fully implemented.

- MySuper only commenced for new employer contributions on 1 January 2014 and many funds will need to conduct costly product rationalisation of previous arrangements prior to 1 July 2017; and
- SuperStream is also only in the early phases of implementation. The full benefits of this critical reform will not be felt for at least another two years once funds complete the transitioning-in of all Australian employers onto the new e-commerce arrangements.

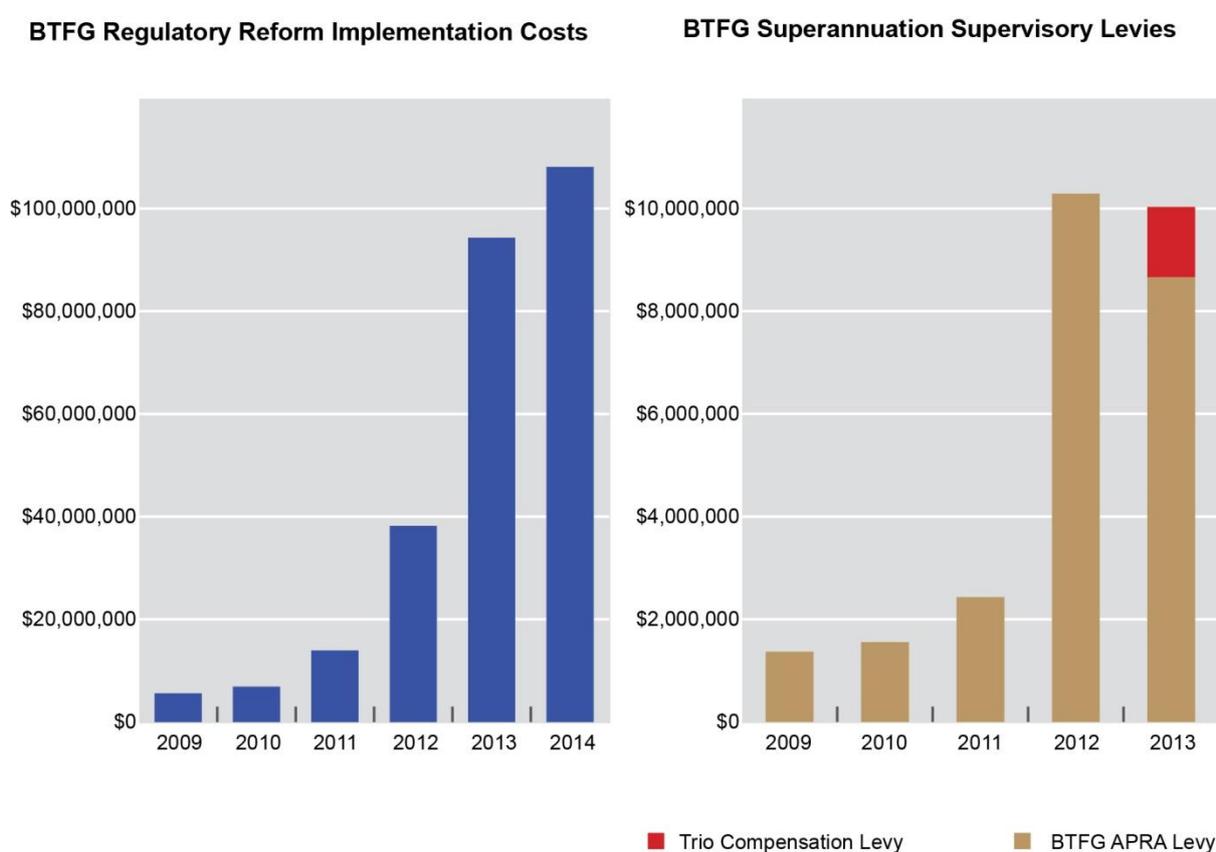
⁴⁹ Mercer Global Pensions Index, 2013

⁵⁰ Chant West, Media Release, *Super funds hit double digits again in 2013/14*, July 2014

These legislative reforms have come with a substantial monetary and opportunity cost to superannuation providers. Prior to the implementation of the above mentioned reforms, BTFG had a three-year average spend on legislative reform implementation costs of \$9 million. For the past two years, BTFG has spent approximately \$100 million per year implementing legislative reforms.

In addition, all superannuation funds have also had to absorb the Government's own costs in implementing such a large reform agenda. These costs have been passed on to funds and fund members by the annual APRA Superannuation Supervisory Levies (normally paid in November each year). Figure 13 provides further details.

Figure 13. BTFG Regulatory Reform Implementation Costs and Superannuation Supervisory Levies



It is too early to judge the success of MySuper and SuperStream given organisations will still be implementing aspects of the reforms until July 2017. Westpac does not believe that maintaining these unprecedented levels of regulatory change on an ongoing basis is desirable given the costs imposed on members.

a. Bi-partisanship required to deliver much needed intergenerational policy stability

Both legislated policy change, and also the various reviews and inquiries into superannuation, are creating a lack of confidence in the stability of superannuation policy settings. To ensure continued community confidence in Australia's superannuation system, policy stability is required.

Westpac supports the creation of an independent statutory advisory body to provide oversight and policy advice to government. Advice from this body would be made public to help inform public debate and engender confidence that changes were being contemplated for the right policy reasons based on the relevant facts. There is also an important supporting role in this new architecture for the Intergenerational Report to better inform superannuation policy settings through more detailed projections of system outcomes.

Only through increased transparency in policy advice and a greater focus on the unique intergenerational aspects of superannuation can policy stability be increased.

To ensure any new independent superannuation statutory advisory body is enduring, Westpac believes the core guiding principles and legislative structure should be established via the work of a joint parliamentary committee.

b. Policy stability is undermined by current tax expenditure methodology

In recent times, there has been an unprecedented level of annual budget-driven changes to superannuation tax settings. Policy stability in taxation settings is undermined by the way that Treasury calculates the foregone tax revenue from superannuation tax concessions in the annual Tax Expenditure Statement. These concerns have been well documented over recent years.

Instead, the benefits and costs of the superannuation system should be looked at holistically as part of the regular Intergenerational Reports which have the capacity to properly examine the long-term impact of the system on the Federal Budget - including on age pension outlays.

4.2 Competition in superannuation (2-115)

Does, or will, MySuper provide sufficient competitive pressures to ensure future economies of scale will be reflected in higher after-fee returns? What are the costs and benefits of auctioning the management rights to default funds principally on the basis of fees for a given asset mix? Are there alternative options?

4.2.1 Performance of MySuper in delivering higher after-fee returns

For most funds, MySuper will have only commenced on 1 January 2014 after having incurred significant expense in becoming compliant and authorised to offer the product. Westpac believes that it will take many years before the full outcome of these reforms are evident.

The impending onset of MySuper has already placed additional downward fee pressure on superannuation providers. The 2013 Rice Warner/Financial Services Council (FSC) Superannuation Fees Report found overall fees for the whole superannuation industry, expressed as a percentage of assets, decreased to 1.12% for the year to 30 June 2013 (compared to 1.20% for the prior 12 months).⁵¹

⁵¹ Rice Warner, FSC Superannuation Fees Report 2013, May 2014

Westpac supports a post implementation review into the performance of the MySuper reforms to ensure they are achieving the intended objective.

However, this review should not take place until all of the related reforms have commenced and had an opportunity to be in operation for a reasonable period of time. Westpac therefore suggests that such a review should be delayed until at least 2020 – noting that the current reforms will not be fully implemented until mid-2017.

Westpac also believes that the realisation of some MySuper benefits could be accelerated through both the removal of anti-competitive default fund provisions, and via the creation of a member centric product rationalisation framework that can assist to modernise the sector.

Further, there is value in exploring whether additional mechanisms could be introduced to allow APRA to revoke or place conditions on any MySuper fund that has consistently under-performed their target rate of return (net of fees), and/or an appropriate risk-weighted peer group, over a five-year period.

4.2.2 Limitations on employer default fund status are anti-competitive

Westpac supports the Interim Report's observation that *'the selection of default funds in awards largely reflects precedent and is not subject to a competitive process.'* Industry experts have estimated that 50% to 58% of the workplace superannuation market is 'locked-in' to Modern Award approved super funds.⁵²

Competition encourages firms to deliver products and services as efficiently as possible to win and retain business. The current Modern Award arrangement limits the number of market participants from competing for business and rewards affiliations over superior performance and pricing that would 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. Active employer decisions will force default superannuation funds to carefully consider how they price and service members. Competition exposes poor performers to the market, as employers move towards funds that have established themselves as consistent performers.

The corporate superannuation market provides the best example of how an open default fund market could operate. Where employers are not bound by Modern Awards, they can select their short list from all providers based on the needs and demographics of their employees. Each provider is then required to put forward their unique offering and capabilities, servicing model for members, pricing, and insurance design to obtain the rights to act as the employer's default fund.

This process drives strong market competition. While the average superannuation fee is around 112bp, the final pricing in this segment is typically driven down to a range of between 50-70bp.⁵³

⁵² Rafe Consulting, *Impact of changes to the Fair Work Act on the Australian Superannuation Sector*, June 2014
Rice Warner Actuaries, *Default Funds In Modern Awards - Report*, April 2013

⁵³ BTFG corporate superannuation data

Given the present barriers to competition in default superannuation, incumbents benefit from their position and are not able to be 'disrupted' by other providers. This slows the process of innovation and at the same time keeps prices artificially higher than would otherwise be the case.

Critically, the introduction of MySuper from 1 January 2014 has provided the right environment for the Government to open up the default market to competition. The MySuper legislation has ensured that all default superannuation funds must meet new minimum standards, considerably higher than previously, as well as being more easily comparable through standardised fees and APRA MySuper reporting.

4.2.3 Recent reports on fee-based competition within superannuation

The Interim Report made several references to a recent Grattan Institute report. Unfortunately, the Grattan Institute report fails to take into account several critical considerations to explain the operating costs of Australia's superannuation system, including:

- the complexity of the Australian legislative architecture that superannuation funds operate within;
- the requirement for Australian superannuation funds to manage a taxation overlay on behalf of each superannuation member, that is subject to frequent change;
- Australian superannuation funds also oversee death, disability and income protection insurance services to their members; and
- Australia's system is a defined contribution system, and as such, has a higher weighting to more expensive growth assets. This has been identified in many submissions to the Inquiry as being appropriate for the age of Australia's superannuation system.

These and other points are outlined in more detail in the Association of Superannuation Funds of Australia (ASFA) and FSC submissions, which are supported by new research prepared by Deloitte Access Economics and Chant West.⁵⁴

At the same time, the Grattan Institute report ignores the returns of the various systems it examines. This is a major structural flaw in their analysis as revealed by subsequent research reports which have now been released. Specifically, the recently released Deloitte Access Economics report, commissioned by the FSC, states that '*of the twelve jurisdictions included in the review, Australia has the third-highest returns.*'⁵⁵

4.2.4 Chilean Model would require an unprecedented level of government central planning

The Interim Report questions whether the recent superannuation reforms and increasing scale will adequately bring down fees and costs in the system. This theme is also raised in the recent Grattan Institute report. Both reports raise the use of a national tender for default fund status (Chilean Model) as a possible additional intervention to further drive down superannuation fund fees.

⁵⁴ Deloitte Access Economics, *Financial performance of Australia's superannuation products*, August 2014

⁵⁵ Ibid

Westpac contends there has already been an unprecedented level of intervention in the superannuation sector over recent years and that time is required to allow the benefits of these reforms to be realised. It is wrong to judge the outcomes of these substantial and costly reforms before they have fully commenced.

Critically, these reforms were themselves the product of a comprehensive review of the superannuation sector, the Super System Review. Among several other changes, the Super System Review resulted in the introduction of MySuper and SuperStream, which it stated would:

- improve the simplicity, transparency and comparability of default superannuation products; and
- enhance the 'back office' of superannuation. When fully implemented, these measures will improve the productivity of the superannuation system and make the system easier to use.⁵⁶

In addition to these recent reforms, Westpac in general has public policy concerns with the concept of a national tendering model.

A national tendering model would force funds to focus disproportionately on the price aspects of their offering rather than ensuring the best retirement outcome for their members. Funds would be incentivised by the model to move to cheaper, less growth-oriented assets. Government would then need to respond by trying to micro-manage asset allocation for members. There would also be an ongoing temptation to use this mechanism to meet other public policy objectives such as funding government or public infrastructure.

Having a single system-wide view of what the ideal investment allocation ought to be would also lead to a substantial rise in highly correlated investment portfolios and therefore higher systemic risk.

Government would also need to take on a degree of responsibility for the mandated investment model undermining much of the public benefit of a privately managed retirement savings pool. Given the almost certain likelihood of there being higher performing funds outside of the selected few, it would also expose the Government to criticism for having excluded other providers.

Funds would also be incentivised by the model to offer either no or a minimal level of member servicing. Once again, Government would need to respond by setting ever greater levels of detailed legislative criteria for obtaining default fund status.

The current ability of MySuper providers to customise elements of the default offering allows employers and funds to ensure the offering is appropriate for the demographic profile of their workplace. Under a national tender scenario, this flexibility would no longer be available to the detriment of members.

It is important to reiterate that the underlying basis of the international comparisons which prompted the Grattan Institute to recommend this form of Government intervention has now been widely challenged by more detailed research commissioned by ASFA and the FSC.

⁵⁶ <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=reforms.htm>

This research, conducted by Chant West,⁵⁷ found that the Grattan Institute report wrongly compared Chilean administration fees with the total of administration and investment fees for MySuper products. The investment fees of external fund managers used by Chilean default funds are not covered by their administration fees. While these fees are not directly deducted from a member's account, they are deducted from earnings before they are credited to members' accounts.

According to Chant West's detailed analysis, the Chilean pension system has a total cost of 92 basis points – as compared with 88 basis points for MySuper (based on a weighted average calculation). Similarly, ASFA research has concluded that the lowest fees charged to members in defined contribution schemes overseas are typically 0.8 to 1.0 per cent of account balance and are often well in excess of 1 per cent of assets. ASFA cites numerous other comparable international jurisdictions (including the US and UK) to support their conclusion that superannuation fund fees in Australia are not out of line with fees for defined contribution funds in other countries.

This recent research demonstrates Australia's superannuation system is far more competitive than claimed and is delivering sound after-fee returns for members relative to peer systems – assessed by Deloitte as providing the third-highest returns across a global comparison of 12 other pension systems.⁵⁸

The research affirms Westpac's view that optimal outcomes for members will be delivered through bedding down the current reforms, and the creation of a new competitive landscape by allowing any employer to select any MySuper product as their default superannuation fund.

As stated above, consideration of any alternative model should be deferred until at least 2020 on the basis the current reforms will not be fully implemented until mid-2017.

4.2.5 The current legislative framework impedes product rationalisation

Westpac welcomes the Interim Report's observation that the operational risks and costs to consumers relating to legacy products remain an undesirable feature of the current Australian financial landscape.

Westpac supports the Government continuing the consultative work commenced in the 2009 Treasury consultation paper on product rationalisation. Westpac also notes that the final report of the Super System Review published in 2010 further highlights the additional efficiencies that could be achieved in the superannuation sector by facilitating the rationalisation of legacy superannuation products.

Critical to these benefits being realised is the need to amend the current 'equivalent rights' test to a more flexible 'no overall disadvantage' test as recommended by the Super System Review.⁵⁹

⁵⁷ Chant West, *Chilean Pension System: Relevance for Australia*, August 2014.

⁵⁸ Deloitte, *Financial Services Council*, August 2014.

⁵⁹ Super System Review, Recommendation 10.9, page 320

Given the focus of the Interim Report on ensuring that any impediments to a more efficient superannuation system are addressed, Westpac strongly recommends this overdue legislative reform proceed via a final Treasury consultation process that includes draft legislative amendments. Westpac does not support this measure being further delayed through a referral to the Tax White Paper process. The legislative impediments (including necessary tax rollover relief to ensure no consumer detriment) are well established by industry submissions over the last decade.

4.3 Active and passive investment management within superannuation (2-115)

To what extent is there a trend away from active asset management within asset classes in superannuation funds? Is this a positive or negative development for members?

Westpac believes the Inquiry should reaffirm recommendation 97 of the 1997 Wallis Inquiry which stated that *'superannuation funds should not be required to invest in a particular asset class...subject to the requirements of the Superannuation Industry (Supervision) Act 1993 that they invest prudently in a properly diversified portfolio.'*⁶⁰

4.3.1 Efficiency and active investment management

Efficiency needs to be clearly defined in relation to investments. Contrasted to business and operating efficiency of the superannuation system, efficiency of the investment outcome should be considered in the context of return (after fees) for the level of risk taken (the most important measure for members). This view of efficiency is found to be lacking in the discussion. The focus on fees in isolation is, therefore, to the detriment of members.

'Active' management is a broad term and, in Westpac's view, is best described as the decision making involved in professionally managed portfolios including the governance, asset allocation, strategy allocation, portfolio construction, currency hedging, rebalancing, and cash flow and liquidity management of MySuper assets.

The decision to use an index exposure or to employ an active manager should be made by each fund, in light of the opportunities available in each market. The attractiveness of any strategy should be considered a function of the after-fee risk adjusted performance expectations, and needs to consider characteristics such as diversification, risk management, contribution to risk and return that each strategy brings to the portfolio. Ultimately, funds need to measure, over reasonable timeframes, whether active strategies deliver the expected benefits after fees.

4.3.2 The benefits for 'active' management of MySuper portfolios

Actively managed strategies can often represent a broader opportunity set than passive strategies. For example, the broad range of alternative asset classes such as hedge fund strategies, property, infrastructure, and private equity can be considered as 'active' strategies. Their diversification benefits can be significant to portfolios as can the benefits of a more active approach to the management of more traditional assets.

⁶⁰ Wallis Financial System Inquiry Report, Recommendation 97, March 1997

Actively managed strategies are also better placed to manage risks such as concentration risk, environmental, social and corporate governance risk, stock specific and sector risks and opportunities. Risk and risk management is missing from the fee debate and by proponents of passive allocations. Members of superannuation funds experience the absolute risk and return outcomes and commonly proponents of passive strategies will overlook the level of risk embedded in the benchmarks used.

Diversification and risk management are key to delivering portfolio outcomes. Practical examples where a purely mandated passive approach would not work are:

- when diversifying away from the dominance of equity risk in portfolios, the use of strategies outside of traditional passive approaches is required. Diversification is found lacking in many indices and typically they are dominated by a particular security, sector or country;
- managing different risks at different times of the investment lifecycle. Indices are generally not defined by any parameters of risk other than some basic liquidity measures. Currency risk for example may be prevalent within an index but hidden within the capitalisation construct. Environmental, social and corporate governance risks are not considered in typical price weighted indexes.

Westpac believes there is merit in a system that encourages long-term strategies which have a greater focus on absolute return outcomes. Over the last 30 years investment managers and superannuation funds have become more focused on relative returns than absolute returns. They have arguably lost focus on the key considerations for MySuper members, being risk management aligned with capital preservation and performance outcomes measured through the parameters of sufficient reward for risk taken. It should be recognised index strategies do not provide a holistic solution to these objectives.

4.4 Self-managed superannuation funds (2-117)

Restore the general prohibition on direct leverage of superannuation funds on a prospective basis.

The Interim Report makes a number of observations and poses several questions in relation to SMSFs. While Westpac supports these areas of focus, there continues to be need for a wider consideration of the regulatory perimeter for SMSFs.

In particular, Westpac believes the current level of oversight and analysis of the systemic implications of the sector is insufficient given its size and continued growth. This poses important issues for the Government and SMSF members including:

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

This lack of oversight is compounded by the generally poor quality and depth of official data in relation to SMSFs. We continue to encourage the Inquiry to consider ways that these matters can be addressed.

4.4.1 Leverage

Westpac believes the current take-up of borrowing by SMSF's is a rational response to the current policy and tax settings. Interest expenses from lending can offset other taxable earnings within the fund and the sale of large property assets can be deferred until retirement to ensure no capital gains tax is payable.

Westpac is a participant in the SMSF lending market and applies conservative lending practices to this activity. Specifically, Westpac applies a maximum LVR of 80% for residential property and 65% for business real property.⁶¹

The Interim Report recognises that direct leverage in superannuation funds is embryonic but growing. The Interim Report also notes that the current ability of funds to borrow directly may, over time, erode the superannuation system's ability to act as a stabilising influence on the financial system during times of stress. The Interim Report also highlights that removing direct leverage in superannuation is consistent with the concept that superannuation tax concessions should apply to funds that have been saved and not borrowed.

Westpac supports all of these observations and we acknowledge there are systemic benefits to a large unleveraged savings pool, which can act as a stabiliser in times of stress.

Any change to the requirements surrounding leverage, like any others in superannuation, should operate on a prospective basis – consistent with the Interim Report's policy option.

Should the Inquiry decide not to remove direct leverage, we encourage the Inquiry to instead consider how appropriate caps – at an SMSF level – can be introduced to ensure leverage does not become a systemic risk.

4.5 SMSF suitability (2-126)

- To what extent should the Inquiry be concerned about the high operating expenses of many SMSFs?
- Should there be any limitations on the establishment of SMSFs?

Westpac believes that, irrespective of the Inquiry's final conclusions on direct leverage, suitability remains the most important policy consideration in relation to SMSFs.

Whether operating expenses are unduly high is secondary to whether the individuals who are deciding whether to establish an SMSF are doing so on a properly informed basis.

Additionally, and just as importantly, given the unique structure and risks attached to SMSFs, consideration should be given to higher qualification and accreditation requirements for advisers in this area.

⁶¹ Westpac SMSF Lending Criteria

For example, Westpac does not automatically permit all financial advisers to provide advice on SMSFs. Only those advisers that have been specifically authorised (as a result of having completed additional SMSF-specific training), and whose role scope permits SMSF advice, are able to advise in this area. Once authorised, the individual must also meet continuing education requirements, including specific knowledge areas to maintain their authorisation in this area.

Additional education is required before the adviser is able to offer advice on SMSF gearing strategies.

Critically, even Westpac advisers that are authorised to provide advice on SMSFs are still unable to provide a range of services, including:

- SMSF trust deed establishment and/or review;
- acting as trustee;
- making payments on behalf of a trustee;
- accounting services or tax advice;
- compliance reporting functions (such as Financial Statements, ATO reporting, Instalments Activity Statements and PAYG summaries);
- actuarial services;
- audit services;
- legal advice; and
- completion of administrative tasks to wind up the SMSF.

This list highlights the legal complexity of establishing and operating an SMSF and supports the need for appropriate limitations on the establishment of an SMSF. This is needed to ensure individuals are properly informed of the risks they are taking on, and the complexity of their arrangements.

As a result, Westpac also imposes a minimum balance threshold of \$200,000 before an adviser is able to recommend that an SMSF be established (with establishment to be fulfilled through a third party adviser), with a clear escalation process to deal with any exceptions where an SMSF is in the best interests of the client.

In light of the complexity, ongoing administration and unique risks, Westpac encourages the Inquiry to consider the introduction of appropriate additional regulatory requirements before an SMSF is able to be established.

Critically, given the different levels of consumer protection across APRA regulated funds and SMSFs, we support the need for a clearer test needing to be met before the establishment of an SMSF can be recommended. The test would require an adviser/accountant to be satisfied that the benefits from the establishment of the SMSF clearly outweighed the additional risk and complexity relative to an APRA regulated structure.

Chapter 5 – Stability

Westpac Key Issues and Insights

‘Too big to fail’ and moral hazard

- The capacity of private institutions to fail is fundamental to the operation of a market-based financial system. There should be no ‘guarantee’ of individual institutions in the financial system.
- Westpac strongly supports the policy objective that government liquidity support of the financial system in the event of a crisis (as distinct from a ‘guarantee’ of institutions) should operate in a way that minimises the risk taxpayers are directly exposed to loss.
- Australia’s financial system already has strong features that minimise this risk of taxpayer loss, and there is no clear evidence of a systemic vulnerability that these settings fail to address:
 - Australian banks are subject to significant scrutiny from both domestic and international debt and equity investors. These market pressures are important in defining the individual risk management of banks;
 - Australia’s major banks are very well-capitalised, both in absolute terms and when compared with global peers on a consistent basis;
 - Prudential supervision in Australia is conservative, such as in the definition and measurement of capital; and
 - There is an intense level of supervision of D-SIBs, which aims to mitigate any moral hazard risk.
- Any further policy options to address the issue of TBTF should closely consider the efficiency of the financial system, the credit rating of Australia’s banking system and the capacity of the financial system to support economic growth. They are also interconnected and should therefore not be considered in isolation.
- In relation to each policy option, Westpac’s position is summarised below:
 - **Ring-fencing** - The modest scale of Australian banks’ investment banking activities and discretionary investment portfolios, and broader regulatory risk-mitigation measures, reinforce the current lack of justification for any costly and inefficient ring-fencing measures;
 - **Further increasing D-SIB capital requirements** – Increased capital comes at a cost, which is ultimately reflected in higher costs for borrowers. There is no clear basis on which to require additional capital holdings. Australia’s D-SIBs are very well-capitalised to absorb losses, and their capitalisation is at the upper end of global peers. Further, as liquidity support of the financial system has been the primary nature of government support in Australia, it is not clear that increasing capital requirements further will necessarily reduce the call on government in a liquidity crisis;

- **Imposing losses on creditors ('bail-in')** – Westpac believes any bail-in regime for Australia should be carefully designed for domestic circumstances in consultation between government, regulators and the banking industry. Any recommendations regarding bail-in should also be undertaken with the benefit of the outcomes of the G20 Brisbane Summit. There is no clear advantage in Australia being an 'early mover' in implementing bail-in measures compared with the rest of the world;
 - **Resolution powers and pre-planning** - Westpac supports the development of a sound resolution framework in Australia, and will work closely with regulators to develop this framework in a manner which is appropriate for Australia's financial system; and
 - **Stress-testing** - Westpac recommends the increased use of stress testing as a sound means of assessing the strength of Australia's banking system and the need for any additional regulatory and prudential measures to deal with TBTF.
- Ultimately, Westpac believes the totality of the financial system's stability settings are most important in managing TBTF and moral hazard risk, rather than any one, individual policy measure or individual bank focus.

Other policy options in Chapter 5 Stability

- Westpac supports the continuation of the Financial Claims Scheme (FCS) as a post-funded scheme. Westpac does not believe that the FCS should be pre-funded.
- Westpac believes that the existing toolkit available to APRA and the RBA is appropriate for macro-prudential supervision.
- Westpac supports public reporting of regulator-endorsed internationally harmonised capital ratios.

Chapter 5 – Stability

As Westpac outlined in its Initial Submission, Australia’s financial system is sound, resilient and well-managed. The regulatory framework applying to the financial system is generally effective. While maintaining the effectiveness of the regulatory framework – and the stability of the financial system – Westpac continues to press on the Inquiry the importance of taking account of growth and financial system efficiency in determining regulatory settings.

Westpac’s response to the Interim Report’s observations regarding stability focuses on the issue of ‘too big to fail’ (TBTF) and moral hazard.

Following the discussion regarding TBTF, the other policy options raised by the Interim Report in its Stability chapter are also addressed.

5.1 Too big to fail and moral hazard

The Interim Report seeks stakeholder views on TBTF and moral hazard. The Report raises a number of policy options designed to minimise perceptions that some institutions are TBTF through ‘*making an orderly resolution more likely with minimal need for Government support, and reducing the probability that such institutions will fail.*’⁶²

The specific, and inter-linked, policy options raised from page 3-8 of the Interim Report are:

- No change to current arrangements;
- Imposing losses on particular classes of creditors during a crisis;
- Strengthening regulators’ resolution powers for financial institutions;
- Investing more in pre-planning and pre-positioning for financial failure;
- Further increasing capital requirements on financial institutions considered to be systemically important domestically; and
- Ring-fencing critical bank functions, such as retail activities.

These policy options, along with the relevant aspects of the TBTF debate, are addressed below.

5.2 Key elements of the TBTF policy debate

The capacity of private institutions to fail is fundamental to the operation of a market-based financial system. Westpac endorses this principle.

There are several important elements that Westpac believes should be considered to enable an informed policy debate regarding TBTF:

- developing a clearer understanding of ‘government support’ in the context of TBTF, distinguishing in particular between liquidity and solvency support;

⁶² FSI Interim Report, p.3-9

- distinguishing between solutions that would effectively address individual distressed banks but that would not necessarily address the situation where there is a crisis of the banking system overall;
- recognising the strength of Australian bank capital adequacy on a basis that is truly consistent with offshore peers, and the intensity and effectiveness of prudential supervision in Australia. Both of these factors are central to how the system currently manages probability of failure and moral hazard; and
- the long-term opportunity costs associated with the policy options the Inquiry has raised to further address TBTF.

5.2.1 Government support

Westpac notes that some forms of Government support were extended to Australian ADIs during the GFC.⁶³ Moreover, there are acknowledged benefits to the rating of Australian banks from the assessment that in a crisis those banks would receive some form of extraordinary support from government. Moody's and S&P recognise this support, and accordingly apply a rating uplift to individual bank's ratings based on a combination of the fiscal capacity of the Government, and the likelihood of support from the Government.

This perceived benefit and rating uplift translates into lower cost of funding for the Australian economy through Australian banks, and in turn corporate and individual borrowers. It is an important benefit for the economy.

Government support is, however, frequently assumed to be synonymous with 'solvency support' or 'bailing-out' the banks. The reality is that government support can take many forms. At one end of the spectrum, some overseas governments have found it necessary to use taxpayers' funds to support the solvency of troubled institutions via injections of new equity. At the other end, there is a long standing consensus⁶⁴ that governments should stand ready to provide liquidity support to sound institutions where markets cease to function effectively due to a lack of confidence or external disruption (e.g. 9/11). Between these options, the RBA has observed that there may be some limited scenarios in which governments may want to retain the option of taking equity stakes rather than operating in a 'black and white' world where this option is never available.⁶⁵

In the event of a financial crisis, it is generally accepted that governments should stand ready to intervene to ensure the basic functions of the financial system. This would include that liquidity remains available, the payments system remains operational and credit continues to be available to support economic activity. Critically, government's support of the continuation of these functions is of benefit to the economy and community as a whole. Equally importantly, it does not necessarily require that individual institutions be allowed to escape any adverse consequence to the extent their own failures have triggered or amplified the crisis.

⁶³ The Australian government facility under which all Australian banks were able to purchase a government guarantee of certain defined obligations, and deposits up to \$1million were guaranteed without explicit charge. The government guarantee facility is now closed and the threshold for the deposit guarantee under the Financial Claims Scheme reduced to \$250,000.

⁶⁴ Codified as "Bagehot's Law" based on principles set out by Walter Bagehot in the book *"Lombard Street"* published in 1873

⁶⁵ RBA, Submission to the Financial System Inquiry, March 2014, p. 60

Providing access to liquidity to support these functions should be distinguished from intervention to 'guarantee' the continued solvency and operations of individual institutions in their current form – this guarantee does not exist in Australia's financial system and, in Westpac's view, nor should it.

Because access to liquidity to support vital financial functions is the primary nature of government support in Australia, increasing capital requirements for banks, or creating a structured bank resolution framework ('bail-in'), will not necessarily decrease the call on government in the event of a liquidity crisis. A risk of imposing those measures could actually be, in certain circumstances, to make access to liquidity for Australian financial institutions more challenging should they negatively affect bank credit ratings. These issues are discussed further below.

Similarly, increasing capital requirements for banks, or introducing bail-in, will not reduce the perception of government liquidity support of the financial system. Liquidity risk can and does arise in well-capitalised, well-functioning systems. A good test for this proposition is to consider whether the measures taken by the Australian Government to provide liquidity support to the banking system during the GFC would have been any different had banks been required to hold any further capital, or if Australia had introduced bail-in.

Indeed, the perception of government liquidity support of the financial system should not be a matter of concern to policy makers, nor does that perception increase moral hazard risk. Government liquidity support has been made available to all financially viable institutions in times of a system-wide liquidity problem, regardless of their size.

Westpac strongly supports the policy objective that government support of the financial system in the event of a liquidity crisis should operate in a way that minimises the risk that taxpayers are directly exposed to loss. In considering the best practical way to achieve this policy objective, and in light of the commonality of Australian bank balance sheets and the intense level of prudential supervision, Westpac believes it is the totality of the financial system's stability settings that is most important, rather than any one, individual policy measure or individual bank focus.

5.2.2 Current features of Australia's banking system relevant to TBTF

The consideration of policy options to deal with 'TBTF' should be based on a comprehensive understanding of the current strength of Australia's banking system, particularly in comparison to banks in other jurisdictions which may appear in some cases to be more strongly capitalised.

As stated by the International Monetary Fund in its 2012 Financial System Stability Assessment of Australia:

*'Major banks are conservatively run, well-capitalised and profitable and they are likely to withstand severe shocks.'*⁶⁶

⁶⁶ At page 1: <http://www.imf.org/external/pubs/ft/scr/2012/cr12308.pdf>

Since the GFC, Australia's major banks have focused on increasing the quantity and quality of capital, increasing liquidity holdings and improving resilience of their funding models. In that time, Westpac has:

- Increased its capital levels by around 40% between September 2007 and March 2014;⁶⁷
- Managed an eight-fold increase in liquid assets. Westpac commenced the 2007 calendar year with around \$14 billion in liquid assets, which had increased to \$127 billion by 31 March 2014; and
- Materially improved its funding mix by increasing the deposits proportion by 25% and reducing the proportion of short-term wholesale funding by one third.

In each case, Westpac began strengthening its balance sheet in anticipation of, rather than as a response to, global regulatory change. As a result of these steps, and similar steps taken by the other major banks, Australia's banking sector is significantly stronger than it was before the GFC.

Australian banks are also well supervised, and, in the case of Australia's domestic D-SIBs, even more stringent obligations have been put in place to further strengthen their balance sheets and minimise moral hazard risk. Specifically, from 1 January 2016, APRA will apply an additional higher loss absorbency requirement of 1% of common equity Tier 1 capital for each D-SIB.

The regulatory environment seeks to ensure that no institution is able to take excessive risk which would jeopardise the financial system's stability. Adequately resourcing this form of prudential supervision is costly, both for government and for the banking system, but is ultimately beneficial. Westpac supports these arrangements.

a. Absolute capital strength

Australian banks' capitalisation is significantly stronger than before the GFC. Of the current arrangements relating to the stability of the financial system, the capital strength of Australia's banking system is a stand-out feature.

Westpac's initial response to the GFC was to substantially increase its capital strength and this process received further impetus with the release of Basel III in December 2010. Westpac today holds approximately \$8.5 billion more common equity than it would have under the target capital structure the bank had in place in 2007, before the GFC. The amount of Additional Tier 1 and Tier 2 capital held has also kept pace with growth in the balance sheet. Importantly, the quality of Tier 1 and Tier 2 capital has been substantially upgraded, as old instruments are replaced with Basel III compliant structures with enhanced loss absorption features.

⁶⁷ At 30 September 2007, Westpac had a total equity to assets ratio of approximately 4.7%. At 31 March 2014, that ratio had reached 6.8%. This movement does not take account of any risk weighting adjustments.

Regular internal stress testing continues to support Westpac's view that it is very well capitalised, and that its balance sheet and overall business model would be resilient even in the face of a very severe recession. For example, Westpac uses a severe recession scenario to estimate stress in its asset portfolio. This scenario assumes a significant reduction in consumer spending and business investment leads to six consecutive quarters of negative GDP growth, resulting in a material increase in unemployment and nationwide falls in property and other asset prices. The results are shown in Figure 14 below.⁶⁸

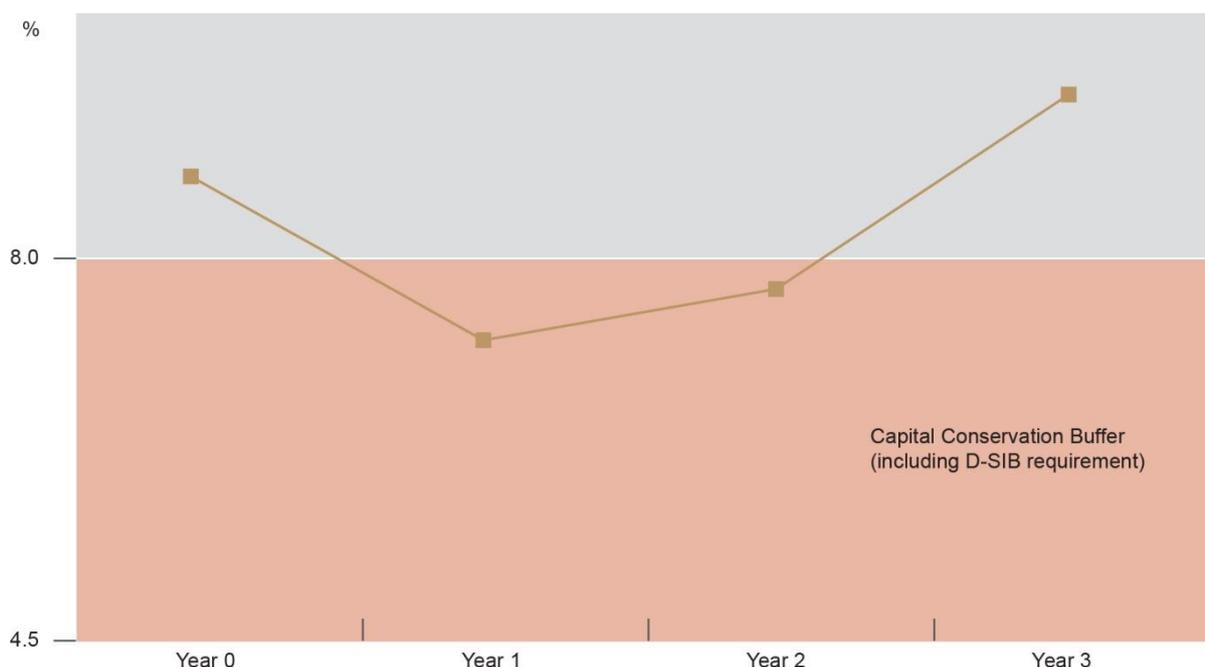
Figure 14. Westpac asset portfolio stress testing

Portfolio stress testing as at 31 March 2014				
Key assumptions	Stressed scenario			
	Current	Year 1	Year 2	Year 3
Portfolio size (\$bn)	565	558	527	517
Unemployment rate (%)	5.8	11.6	10.6	9.4
Interest rates (cash rate, %)	2.5	1.25	1.25	1.25
House prices (% change cumulative)	0.0	-13.0	-22.4	-26.2
Annual GDP growth (%)	2.8	-3.9	-0.2	1.7
Key outcomes				
Stressed losses	12bps	115bps	107bps	32bps

Under this severe recession scenario, Westpac's Australian asset portfolio could be expected to record cumulative losses of \$13.7 billion over three years. While losses of this scale are substantial in dollar terms, they would be manageable within Westpac's risk appetite and capital base. This is shown in Figure 15 below, illustrating the impact of losses to the asset portfolio on Westpac's Common Equity Tier 1 (CET1) capital ratio.

⁶⁸ Westpac Group First Half 2014 Presentation & Investor Discussion Pack, at p.77

Figure 15. CET 1 Ratio and severe recession scenario portfolio losses (for illustrative purposes only – capital numbers are not harmonised)



To highlight the role of the capital buffer in absorbing stress, the modelling illustrated in Figure 15 assumes only that dividends are reduced to meet the Capital Conservation Ratio (CCR) requirements of the Capital Conservation Buffer (CCB). The CCB works in combination with the CCR to ensure that banks conserve and rebuild capital should they encounter a scenario where elevated losses cause their capital ratio to fall inside the CCB range. D-SIB banks in Australia are required to hold a 3.50% CCB, which is 1% higher than the standard Basel III requirement.

The CCB threshold shown in Figure 15 includes the additional 1% of CET1 required to be held by Australia's D-SIBs. It is a sign of Westpac's capital strength that, even under a severe recession scenario, internal modelling indicates that it will still be able to maintain a CET1 ratio that is above the CCB threshold that would apply to banks which aren't required to hold this additional 1%.

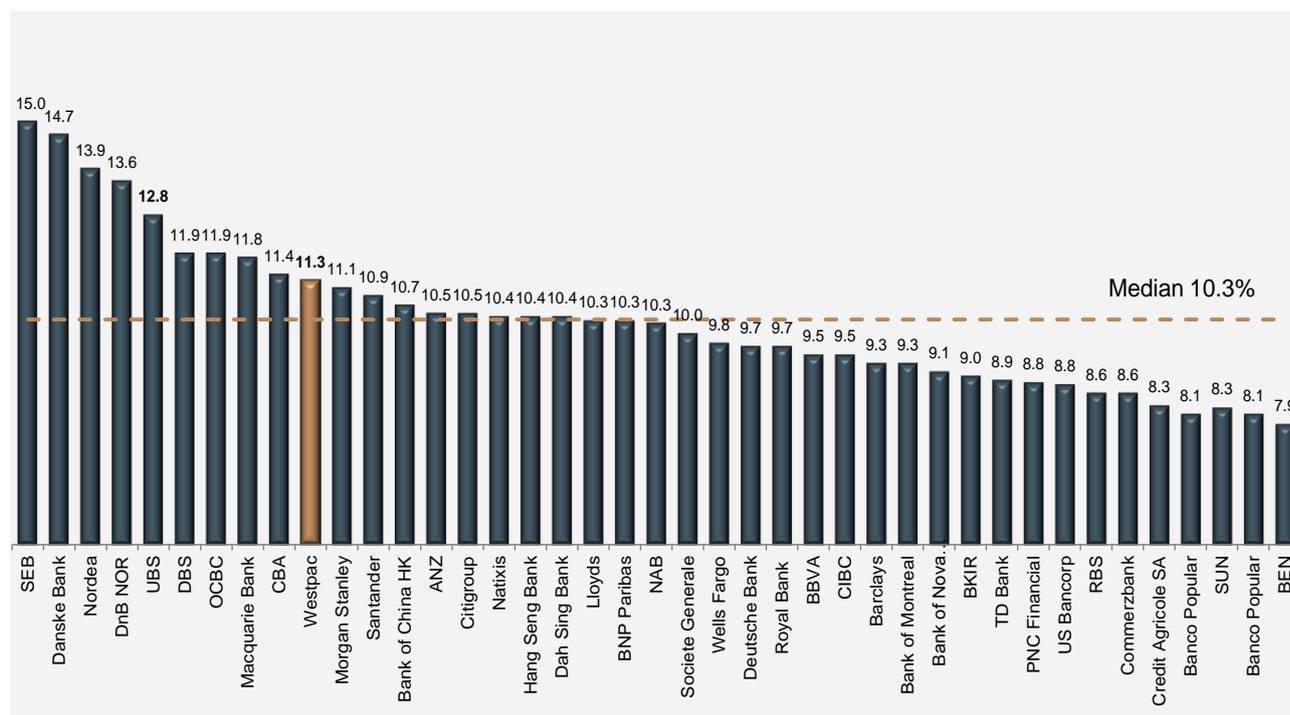
In practice, Westpac would also seek to reduce the impacts of such a scenario on earnings and capital via other discretionary responses such as reducing expenses and repricing the balance sheet for higher risk. Westpac would also have the option of issuing equity to accelerate the capital rebuilding process.

b. Relative capital strength

In addition to capital strength in absolute terms, Australia's banks are very-well capitalised when compared with global peers on a consistent basis. Westpac's fully harmonised Basel III CET1 capital ratio was 11.3% at 30 March 2014, which a number of analysts - including Credit Suisse - estimate is at the upper end of global peers and well above the global median.⁶⁹

⁶⁹ Westpac Group First Half 2014 Presentation and Investor Discussion Pack, pp.59-60

Figure 16. Global peer comparison of Basel III pro-forma common equity tier 1 capital ratios⁷⁰ (%)



In contrast, the Inquiry observes that:

‘Australia’s bank capital ratios...are around the middle of the range relative to other countries...’⁷¹

Westpac believes this observation is not correct in respect of the large Australian banks that lie at the heart of the TBTF policy challenge. It does not appear to take full account of the conservative stance taken by APRA in implementing Basel III in Australia, which results in a significant variance between capital measured under APRA and fully harmonised against Basel III minimum standards. This conservatism is reflected in several aspects of the prudential framework, and was also encapsulated by APRA in its deliberations on Australia’s D-SIB capital surcharge:

‘One of the hallmarks of APRA’s prudential regime is its conservative approach to the definition and measurement of capital. This approach is widely acknowledged, including by the IMF, FSB and credit rating agencies...taking these various considerations into account, particularly its more conservative approach to capital, APRA believes that a HLA requirement at the lower end of the range used elsewhere is appropriate in Australia.’⁷²

To illustrate the practical effects of Australia’s conservative prudential regime, Figure 17 shows a reconciliation of CET1 calculated under APRA’s methodology with CET1 fully harmonised under BCBS minimum standards.

⁷⁰ Company data, Credit Suisse estimates (based on latest reporting data as at April 2014). Australian banks based on IH 14 results.

⁷¹ FSI Interim Report

⁷² APRA, *Information Paper Domestic Systemically Important Banks*, December 2013, pp.19-20. For example, the IMF in its 2012 Financial System Stability Assessment, stated that ‘major banks are conservatively run, well-capitalised and profitable and they are likely to withstanding severe shocks.’

Figure 17. CET1 APRA to BCBS Basel III Reconciliation (at 31 March 2014)⁷³

Description	Common equity tier 1 ratio
Westpac's common equity tier 1 capital ratio under APRA Basel III	8.82%
Under BCBS, supervisors have the option of applying concessional thresholds when determining the capital requirements of deferred tax assets, investments in non-consolidated subsidiaries (NCS) and equity investments in commercial entities held in the banking book. Risk weighted asset treatments apply in lieu of common equity deductions if these items are individually less than 10% and together less than 15% of common equity. To the extent the amounts are greater than the concessional thresholds, common equity deductions apply	
APRA has chosen not to apply this concessional treatment and requires a 100% deduction from common equity for deferred tax assets, investments in non-consolidated financial institutions, NCS, equity investments, and all under-writing positions in financial and commercial institutions held for more than 5 business days	+107bps
Westpac's common equity tier 1 capital ratio would increase if APRA applied concessional thresholds	
Mortgage risk weights under APRA are based on a minimum loss given default (LGD) of 20%, whereas BCBS sets a minimum LGD of 10%. The actual LGD used must be supported by historical data but APRA's higher minimum means that Australian mortgage risk weights are typically higher than those calculated using the lower BCBS LGD minimum	+73bps
APRA applies a risk weighted asset requirement to Interest rate risk in the banking book (IRRBB). This is not currently considered under BCBS standards	+24bps
Other differences, including treatment of specialised lending	+40bps
Westpac's fully harmonised Basel III common equity tier 1 capital ratio under BCBS	11.26%

While the Interim Report does not disclose the specific capital ratios used for the comparison undertaken to reach the conclusion that Australian bank capital ratios are in the middle of the range, Westpac understands from the Inquiry that Australian bank Quantitative Impact Statement (QIS) data is the basis for the Australian capital calculation. QIS capital adequacy ratios will, however, be lower than the harmonised equivalent as they exclude a number of additional capital requirements for Australian banks, specifically:

- the Interest Rate Risk in the Banking Book requirement – this is intended to reflect the risk that shareholders' equity and other liabilities that have no contractual interest rate obligation may be adversely impacted by changes in interest rates, and is not currently considered under BCBS requirements;
- the 20% LGD 'mortgage floor' – as shown in Figure 17, mortgage risk weights under APRA requirements are based on LGD of 20%, whereas the BCBS sets a minimum LGD of 10%. Not reflecting this requirement in any global comparison will understate the capital requirements on Australian banks using the Advanced IRB model. It is acknowledged that there may be increased convergence of LGD 'mortgage floors' in the future but even this 'convergence' is distinguished by different approaches;⁷⁴ and
- the 'slotting treatment' - the Advanced IRB approach requires that risk weights be based on estimates of the PD, LGD, and Exposure at Default (EAD), which in turn are derived via models based on the historical loss experience of the different types of lending. Supervisors, however, have the discretion to use a 'slotting approach' for certain types of 'specialised lending' where they believe the IRB approach would not be reliable. This alternative approach assigns risk weights based on a matrix of criteria that 'slots' the exposure into a risk category. The types of lending captured by this more conservative treatment include project finance, income producing real estate, object finance and commodities finance.

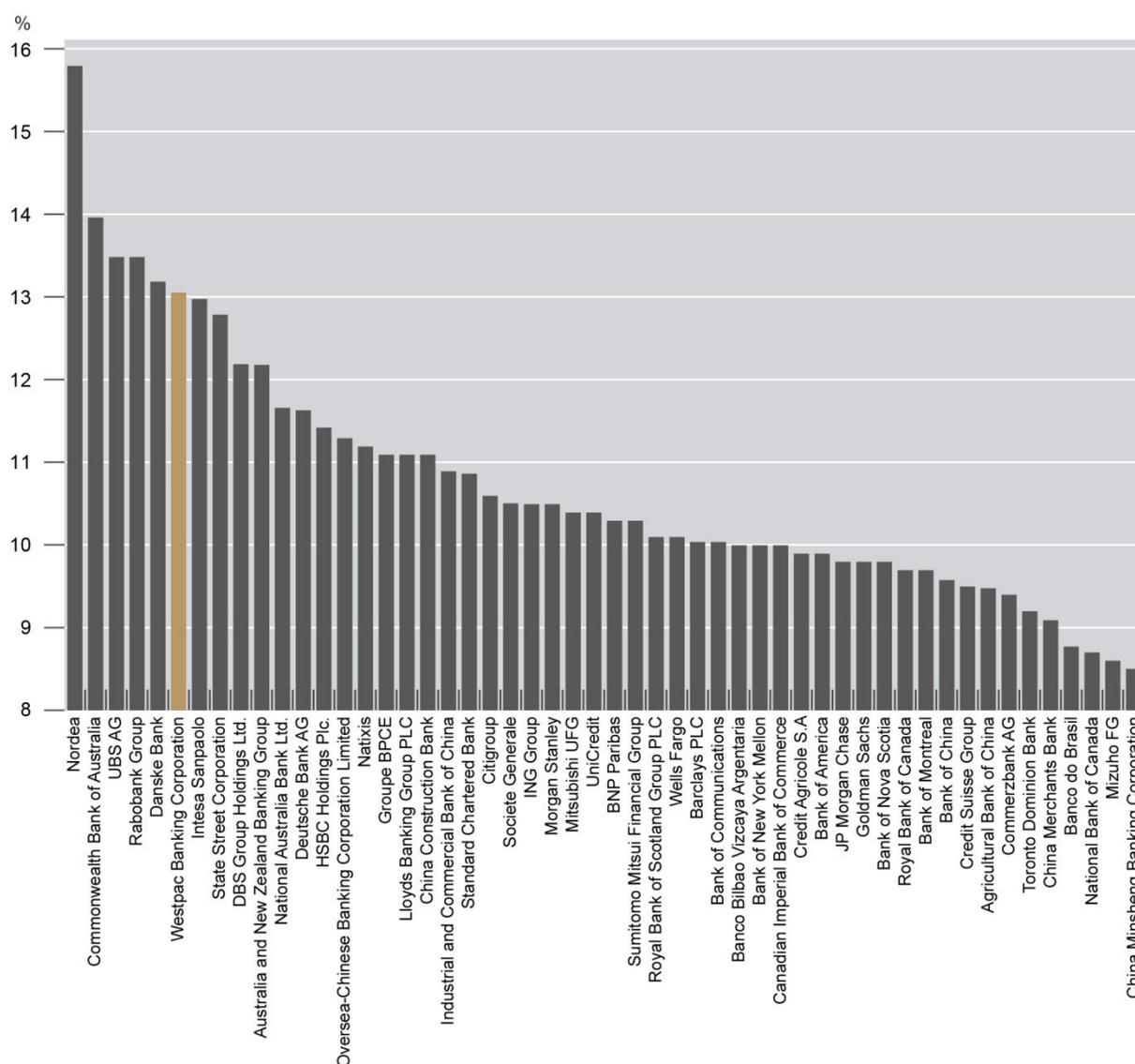
⁷³ Westpac Group First Half 2014 Presentation and Investor Discussion Pack

⁷⁴ Some jurisdictions apply floors via Pillar 1 adjustments that increase RWA while other use Pillar 2 adjustments that result in higher capital ratios.

Finally, the comparison of relative capital strength with global peers is skewed by the use of June and December reporting dates, which are typically⁷⁵ when the contribution of retained earnings that will be paid out in dividends is low for Australian banks but high for global peers with December balance dates. This will be an enduring feature of any capital adequacy comparison that is not based on interim and full financial year-end balance dates.

The capital position of Australia's major banks relative to global peers has also been independently assessed in a PricewaterhouseCoopers (PwC) report, commissioned by the Australian Bankers' Association (ABA).⁷⁶ The study found that, on average, Australia's major banks are at or about the 75th percentile of bank capital relative to the most appropriate comparator set of global banks. According to the PwC report, Westpac's internationally comparable CET1 ratio of 13.07% is in the top quartile of global peers.

Figure 18. PwC report - Westpac internationally comparable CET1 ratio⁷⁷



⁷⁵ CBA with a June year end is an exception to this rule but it will be true for the majority of large Australian banks.

⁷⁶ PwC, *The international comparability of Australian banks' capital ratios*. Report to Australian Bankers' Association, August 2014.

⁷⁷ Figure 18 is a graphic representation of Figure 3 in the PwC report.

Self-reported internationally harmonised capital ratios (such as in Figure 17 above), seek to quantify all differences between APRA and BCBS, as highlighted in the Basel Committee's Regulatory Consistency Assessment Program. Internationally comparable capital ratios, such as the ratio referred to in the PwC report, make further adjustments for APRA's application of BCBS rules, particularly in relation to the application of floors on certain credit risk parameters. Both ratios are intended to provide accurate consistency of capital measures between jurisdictions.

The PwC report observes that not all jurisdictions have applied similar levels of conservatism. In all cases, the adjusted figures better reflect Westpac's own estimates of downturn loss.

Issues regarding comparability of capital reinforce Westpac's view that it would be beneficial to develop greater transparency around reporting capital adequacy, either via supplementing existing measures with a regulator endorsed internationally harmonised ratio, or by reducing the level of national discretion in the calculation of the official capital ratios. This is discussed later in this Chapter.

c. Prudential supervision

Australia's prudential conservatism is reflected not only in the definition and measurement of capital, but also in the very high standards of evidence and proof applied to the ongoing use of risk based models, and a high degree of intensity in prudential supervision. The issues associated with the risk of failure of large systemically important financial institutions were first formalised in October 2002 with APRA's introduction of the Probability and Impact Rating System and the Supervisory Oversight and Response System. These systems assess the probability and impact of the failure of an APRA-regulated entity. Systemically important banks are identified and prioritised for supervisory attention through these mechanisms.

In explaining the rationale for the D-SIB loading that it chose to apply to capital requirements, APRA emphasised the importance of prudential supervision:

'...APRA notes that proactive supervision is likely to be more effective in dealing with the risks posed by D-SIBs than an increase in capital requirements. The Basel Committee has emphasised, and APRA agrees, that other policy tools such as more intensive supervision can play an important role in dealing with D-SIBs. APRA's risk-based approach already subjects institutions that pose greater systemic risks to more intensive supervision and other prudential requirements, and APRA considers this heightened supervisory attention on D-SIBs to be a key aspect in supporting the one % HLA requirement. The importance of APRA's graduated supervisory response system has been acknowledged by the FSB in its Peer Review of Australia (2011).'⁷⁸ [emphasis added]

In addition to conservatism, effectiveness of prudential supervision is also a characteristic of Australia's financial system. Regulatory responsibilities are largely well-defined. Australian bank business models are also relatively simple compared with many complex banking activities overseas, an attribute that supports the effectiveness of prudential supervision.

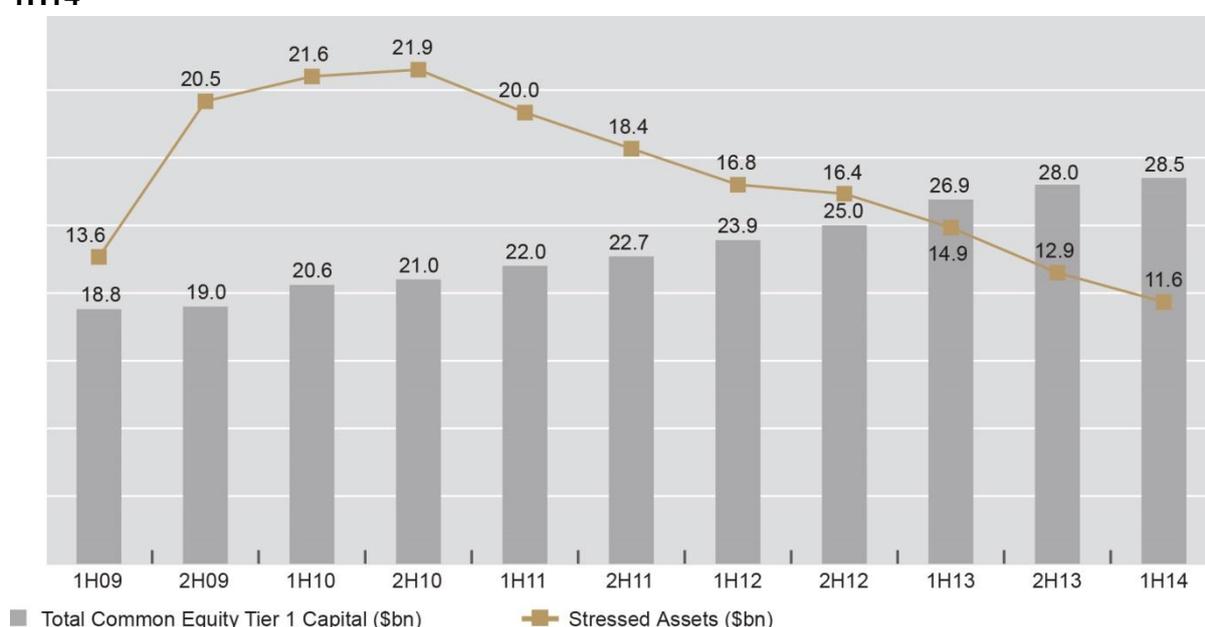
⁷⁸ APRA, *Information Paper Domestic Systemically Important Banks in Australia*, December 2013, p.20

d. Asset strength and moral hazard risk

The asset side of the balance sheet is also an important indicator of the strength of the Australian banking system. Generally, banks have reduced the risk of their asset portfolios following the GFC. This is illustrated in Figure 19, which shows a reduction since the GFC in Westpac's stressed assets and the significant increase in Westpac's total CET1 over the same period.

It has been suggested that moral hazard risk has increased since the GFC, as a result of changed perceptions of the extent of government support of Australia's major banks. One indicator of increased moral hazard would be higher risk asset portfolios. In Westpac's case, the evidence in Figure 19 does not support this.

Figure 19. Westpac Total Common Equity Tier 1 Capital and Stressed Assets 1H09-1H14⁷⁹



Further evidence of the stability of Australian bank assets is provided in Chapter 2 in the context of regulatory capital requirements for mortgages.

Westpac recognises that Basel III requirements are not yet finalised and that the global norms of what it means to be a strong bank may continue to evolve. The Chairman of APRA, in his former capacity as Secretary General of the Basel Committee, has stated that the BCBS is likely to further strengthen and simplify the proposed Basel III rules at the next G20 summit in November.⁸⁰

⁷⁹ Westpac Group Published Financial Results

⁸⁰ Deutsche Bank Equity Research, Australian Banking Sector – Impact from international regulatory news, 13 June 2014

5.3 Policy options to deal with TBTF

The Inquiry has sought stakeholder views on various additional policy options to deal with the issue of TBTF. Westpac believes these options should be assessed from the starting point that Australia's banks are already well-capitalised and strong, that Australia's existing prudential settings are conservative and that Australia's banks are subject to global market disciplines. Policy options should also be assessed in the context in which they have been conceived globally - that pre-GFC systems to address TBTF failed. This was not the experience in Australia.

Moreover, these policy options should not be considered in isolation – in addition to their impact on stability, they should also be viewed in the context of:

- the efficiency of the financial system;
- the credit rating of Australia's banking system, which is a critical factor for the continued ability of Australian banks to effectively access international funding; and
- the capacity of the financial system to support economic growth.

Westpac believes that it is imperative that the potential consequences of these policy options are well understood and articulated, from the perspective of Australia's financial system and economy generally. Achieving this requires Government, regulators and industry to work closely together in assessing the most appropriate solutions for Australia's unique circumstances.

5.3.1 Further increasing capital requirements on D-SIBs

The Inquiry seeks stakeholder feedback on further increasing capital requirements on financial institutions considered to be systemically important domestically, presumably above that already assessed and required by APRA. Importantly, APRA's capital assessment already includes the additional D-SIB capital charge announced in December 2013, which specifically considered global capital comparisons.

Capital can have different functions. In the context of TBTF, the role of capital is to absorb loss and thereby shield other stakeholders, particularly taxpayers, from direct exposure to the risk of loss. It is therefore in this context that the Inquiry should consider whether Australian D-SIBs should be required to hold additional capital.

Westpac has earlier in this Chapter made the case that it is very well capitalised, that Australian major bank capital levels are high by global standards, bank balance sheets are strong, and that prudential supervision is conservative. These are all indicators that there is no clear basis upon which to require additional common equity, particularly when weighed against the potentially adverse effect on the capacity of the system to support economic growth.

Westpac certainly supports the principle that losses be borne by the capital and liability holders prior to taxpayer intervention. Should government choose to provide support to a failing institution, government should be in a superior position to all other unsecured creditors.

However, this does not necessarily require institutions to hold yet more common equity capital. While the ability to absorb loss is a defining feature of capital, the exact manner in which loss can be absorbed is equally important. In practice, there is already a 'hierarchy of loss' that starts with ordinary equity as the first point of loss absorption, and cascades through to Tier 1 and Tier 2 hybrids, senior unsecured funding, deposits and guaranteed deposits.

The extent to which any particular class of capital or liability is exposed to, or shielded from, loss depends on its place in the loss hierarchy. In the event of a winding up of an Australian bank, each of these points of loss absorption would be exhausted prior to depositors being exposed to direct loss. There is therefore currently a deep pool of capital and liabilities that stand between a failing bank and depositors within Australia's system – both in terms of the *level* of capital and the *classes* of creditors that are exposed to loss before depositors.

This 'hierarchy of loss' is shown in Figure 20, which for illustrative purposes summarises the hierarchy within the context of Westpac's liability structure. This hierarchy shows the many layers of protection that preferred deposits (generally, savings accounts and term deposits) benefit from due to the statutory preference they are given in a bank's insolvency by virtue of section 13A of the Banking Act 1959.

This statutory preference, along with the immediate access to cash of up to \$250,000 provided by the Financial Claims Scheme (FCS), largely alleviates the likelihood of any government bail-out being needed to protect household depositors from losing their savings. Such depositor preference provisions distinguish Australia in this regard from many overseas jurisdictions, and lessen the impact of a bank failure on household savings, which is one of the reasons a government would consider a bank 'bail-out.'

Figure 20. Hierarchy of loss post insolvency (in Westpac liability structure)

Lower ranking	Category of liability	Illustrative examples ⁸¹	Size of liability (A\$ billions as at 31 March 2014)
	Common equity Tier 1	Ordinary Shares and Retained Earnings	45.1
	Tier 1 Capital hybrid securities	Westpac Capital Notes 2, and notes or preference shares in respect of TPS 2004, Westpac TPS, Westpac SPS II, Westpac CPS and Westpac Capital Notes	4.8
	Subordinated unsecured debt issued after 1 January 2013 and subordinated perpetual debt	Westpac Subordinated Notes 2013, other subordinated bonds, notes and debentures and other subordinated unsecured debt obligations with a fixed maturity date and subordinated perpetual floating rate notes issued in 1986	1.9
	Subordinated unsecured debt issued prior to 1 January 2013	Westpac Subordinated Notes 2012, other subordinated bonds, notes and debentures and other subordinated unsecured debt obligations with a fixed maturity date	4.0
	Senior debt	Trade and general creditors, bonds, notes and debentures (excluding covered bonds ⁸²) and other unsubordinated unsecured debt obligations (eg deposits that are not protected accounts)	160.0
	Other preferred debt	Other liabilities preferred by law including employee entitlements	1.1
	Preferred deposits without Financial Claims Scheme protection	Protected accounts (generally, savings accounts and term deposits) in excess of A\$250,000.	224.3
	Preferred deposits with Financial Claims Scheme protection ⁸³	Protected accounts up to A\$250,000	164.6
Higher ranking			

It should be acknowledged that the ‘hierarchy of loss’ scenario applies to a winding up situation where a bank is liquidated. Global regulators have also been considering layers of capital in the context of allowing a rapid response to stabilise a bank which is seen to be failing and thus allow for an orderly resolution – specifically, ‘bail-in.’ This is discussed further below.

⁸¹ This table is provided for illustrative purposes only. Liability numbers are based on Westpac’s 2014 Interim Financial Results and Pillar 3 Report.

⁸² Covered bonds represent a senior unsecured claim against the bank with a secured guarantee given by a separate entity which is insolvency remote from the bank.

⁸³ The Financial Claim Scheme does not increase the ranking of these protected accounts, but provides a government guarantee for them. The government then ranks here in respect of reimbursement of the amounts it has paid under the Financial Claims Scheme.

The consideration of loss absorption begs the question of ‘how much capital is enough?’ What is the ‘right’ level of capital? This is partly a question of what amount of loss is believed to be plausible, but also requires that the role of capital be considered in underwriting the process of credit creation by the banking system. Put another way – more capital comes at a cost.

5.3.2 The cost of capital

Some academic opinion suggests that additional capital requirements on banks would not ultimately increase costs to banks or the economy. Westpac does not agree. Increased capital comes at a cost to banks, customers and the economy as a whole through:

- Higher bank funding costs, which are ultimately reflected in higher costs for borrowers;
- A disproportionate impact on higher-risk lending, such as lending to business, which distorts the efficient allocation of capital; and
- More ‘shadow banking’ activity, as regulated institutions become less competitive by having to hold additional capital for similar lending.

These issues are discussed further below.

a. Higher levels of capital lead to higher funding costs

Some commentators (notably Admati and Hellwig) have argued that increasing the overall capital held by banks will not impact the overall cost of funding. This view is inconsistent with the current operation of debt and equity markets globally and in Australia.

The cost of long term wholesale debt funding for the major banks is already based on their overall financial strength and their AA credit rating, the highest level of bank ratings globally. Increasing capital alone would be insufficient to lift credit ratings or influence market sentiment, such that it would materially change the cost of debt funding. While there are differences in funding costs within rating bands, any movement would be insufficient to compensate for the increased cost of higher capital requirements.

In fact, if a rise in capital was expressly predicated on limiting the implicit support of government to the major banks, there is a possibility that credit ratings would reduce and this could see debt funding become more expensive.

It has also been suggested that if a company is less risky, equity investors will be prepared to reduce their required return. While holding more capital may technically reduce the risk of that company’s failure, this investment logic does not hold true when investing in the large major banks. This is because investors cannot afford to bear the cost of a large bank failure in one investment, because the contagion effect and corresponding portfolio impacts would be too severe.

There is no evidence that the banking sector, which has significantly increased its capital level in complying with Basel III, has been re-rated relative to the overall market, or that banks’ required return on equity (required by investors) has been reduced. These conditions would need to occur if investors’ risk/reward position was unchanged.

Given the above, a rise in equity held by the banks will increase a bank's overall cost of funds, which must ultimately feed into pricing models with some, if not all, passed onto customers by way of higher interest rates.

Figure 21 outlines why specific categories of bank funding would not reduce in cost as a result of higher capital levels.

Figure 21. Bank funding responses to increase in capital (and proportion of funding source to Westpac total funding)

Funding Type	Description	%
Equity	There is no evidence to suggest that investors' required return on equity has changed or would change if capital were increased. See earlier discussion. The assumed cost of capital is 11% compared to government bond rate of 3.5%.	7
Deposits	Given their guaranteed status under the Financial Claims Scheme ⁸⁴ , deposit costs would not reduce if capital levels increased.	60
Short term wholesale funding	As investors already charge a very low credit margin for short term debt, because of the implied liquidity and short tenor, any change in funding costs would be immaterial.	17
Securitisation	Securitisation funding costs are relatively immune from the capital strength of the bank as the instruments are already AAA rated because they are backed by mortgage loans. Funding costs typically move relative to the underlying security not the issuer.	2
Long term wholesale funding	There is a small possibility that long term funding costs could improve if capital were increased, although given the major banks are already AA rated, there is limited upside. Indeed, there is a risk long term funding costs could rise as indicated earlier if the banks lose their AA rating.	14

Today, the market's required cost of equity is approximately 750 basis points, while the benefit of lower long-term wholesale funding costs is likely to be less than 10 basis points. Accordingly, it is clear that increasing the level of capital held by banks would lead to overall higher funding costs. This would flow into higher borrowing costs for consumers and businesses.

b. Increasing capital further can disproportionately impact higher-risk lending

Today, the actual level of capital held by banks is in excess of that required under assessed risk (economic capital). It follows that if regulatory required capital levels are increased further, the gap between economic levels of capital and actual levels of capital also increases.

A rise in capital levels above economic requirements distorts the capital allocation process and favours lower risk lending (which requires less capital) over higher risk lending. The higher the additional capital impost, the greater the distortion.

An example of this outcome is reflected in Figure 22, which has been extracted from Westpac's Pillar 3 report for June 2014. It shows the amount of regulatory capital that would need to be held against each exposure class, at a required capital level of 8% of Risk Weighted Assets (RWA) or 10% of RWA. In this instance the level of capital is increased by 25% (from 8% to 10%).

⁸⁴ Up to \$250,000 per account holder per ADI.

Figure 22. Capital allocation to asset classes

	Capital to lending at 8%	Capital to lending at 10%
Corporate	10.64%	13.30%
Business lending	7.06%	8.83%
Mortgages	1.33%	1.66%
Australian credit cards	4.94%	6.18%
Other retail	8.05%	10.06%
Small business	4.05%	5.06%
Specialised lending	9.61%	12.01%
Standardised	11.03%	13.79%

This example is relevant because it demonstrates that the more capital held, the greater the capital impost that is placed on higher-risk lending. If capital required was to be lifted from 8% to 10%, it would mean that significantly more capital would need to be applied to business and corporate lending than to mortgages.

In the above example, for every \$100 dollars of mortgage lending, Westpac needs to hold (on average) \$1.33 of capital. This increases by 33 cents if capital is increased to 10%.

However, for business lending, Westpac needs to hold (on average) \$7.06 of capital for every \$100 of lending. That increases by \$1.77 if the level of capital is increased to 10%.

Therefore, given banks need to generate returns on capital, higher capital levels would disproportionately impact those lending categories that are riskier. This includes large corporates, small businesses, and credit card borrowers.

c. More shadow banking activity

Increasing capital requirements on regulated banks encourages the growth of shadow banking. Because shadow banking is not bound by regulatory capital requirements, those providers can maintain levels of capital close to what is seen as optimal, and so can operate more efficiently than regulated banks. The greater the deviation between actual and economic capital the greater the opportunity. While a shadow banking sector can improve competition, it can also increase risk to the economy and the banking system unless appropriately regulated.

5.3.3 Imposing losses on creditors

A structured bank resolution framework ('bail-in') can be implemented through a statutory or contractual approach. Under statutory bail-in, necessary legislation and regulations are developed which allow the appointed regulatory authority to impose the bail-in requirement on all 'covered' liabilities of the financial institution (covered liabilities would include all liabilities except those which have been specifically excluded from bail-in under the framework). Under a contractual approach, the bail-in regime captures those financial instruments with a specific contractual provision identifying them as being subject to bail-in.

The bail-in of liabilities could be executed through either a write-down of the principal value of the liabilities or through conversion of these liabilities to equity.

Bail-in has significant implications for Australia. It would require careful design for Australia's circumstances, and significant consultation between Government, regulators and the banking industry. Further, Westpac believes that any recommendation regarding the implementation of bail-in for Australia should be undertaken with the benefit of the outcomes of the G20 Brisbane Summit, of which TBTF is an anticipated focus.

Westpac acknowledges the argument that bail-in is likely to reduce the call on government to support the solvency of distressed individual banks, and that this is an understandable policy objective in many nations following the GFC.

It is not, however, certain that bail-in would necessarily reduce:

- The likelihood of a call on government liquidity support for the vital functions of the financial system, which in Westpac's view is the primary nature of government support in Australia (as discussed above); and
- The likelihood of a call on government financial support in highly inter-connected financial systems with broadly similar business models, where a viability concern of a single D-SIB is unlikely to be isolated to that institution. Australia is one such system.

Recent statements from credit rating agencies illustrate that there is a relationship between a bail-in regime and bank credit ratings assessments. This is also an important factor to consider in considering the implementation of bail-in for Australia. For example, S&P has revised its outlook to negative from stable on almost all Canadian banks to which they have ascribed ratings uplift for potential extraordinary government support in a crisis. This followed the Canadian government issuing a consultation paper setting out a proposed bail-in policy framework for large Canadian banks.⁸⁵

The rating of Australia's banking system is a key factor in the price of imported capital, and, indeed, the ability to access that capital at any price. There is also a symbiotic relationship between the rating of Australia's banking system and Australia's sovereign rating – a strong financial system is an identified factor supporting a strong sovereign rating, which in turn supports bank credit ratings.

If a bail-in regime were to be implemented in Australia, several complexities would need to be closely examined. For example, an important objective of the Basel III capital reforms is to simplify the capital structure of banks. A contractual approach to bail-in, however, would potentially result in the creation of an entirely new tier of capital. Yet the alternative, statutory approach to bail-in could result in the establishment of an institutionalised cost of funds disadvantage relative to other jurisdictions without bail-in.

These complexities are highlighted further in jurisdictions, such as Australia, where most large banking groups do not operate under the bank holding company structure which exists in countries like the USA. Banks structured in this way can issue 'bail-inable' debt at the holding company level, without the need to specifically differentiate the instrument.

⁸⁵ S&P Ratings Services, *Outlook on Six Big Canadian Banks Revised to Negative Following Review of Bail-In Policy Proposal*, August 8 2014, p.1

The holding company issuance would be recognised as structurally subordinated for resolution purposes to other senior funding of the bank and priced accordingly. However, for a bank not structured that way and operating under a statutory bail-in regime, all senior debt may be so treated and hence priced accordingly – in effect, an ‘institutional’ rise in the cost of senior debt funding for banks. The issues relating to a holding company structure for banks are discussed in Section 5.3.5 ‘Ring-fencing.’

Further, the implementation of bail-in may also mean that a substantial portion of bond holders able to be ‘bailed-in’ would be based offshore. This could present challenges in Australia’s circumstances. For example, an equity conversion of ‘bailed-in’ debt could result in majority ownership of a large banking group transferring to international investors.

It is for these reasons that it is critical that government, regulators and the industry work closely together to consider the complexities and potential consequences of ‘bail-in,’ to ensure that any Australian solution is appropriate to domestic circumstances.

Addressing TBTF is a central theme of the regulatory agenda for the G20 Brisbane Summit in November. The Financial Stability Board will be tabling proposals for global systemically important financial institutions (G-SIFIs), including the nature of gone loss absorbing capacity (GLAC), the amount of GLAC that should be held by G-SIFIs and where in the structure of banking groups it should be held. The Brisbane G20 Summit will also consider proposals in relation to contractual stays on close-out and cross-default rights of financial contracts as well as cross-border cooperation arrangements. While these measures will be designed for G-SIFIs they will likely have implications for other jurisdictions and the broader design of resolution frameworks.

Consequently, any specific developments in relation to resolution and bail-in should occur after the development of the proposals to be tabled at the Brisbane G20 Summit, so that the domestic framework can be appropriately informed by the development of those international measures. This is vital to ensuring Australia’s financial system is not disadvantaged compared with other jurisdictions.

5.3.4 Resolution powers and pre-planning

Australia is currently developing and implementing comprehensive legal, regulatory and supervisory requirements designed to allow for the orderly resolution of a bank in a way which minimises system impact and avoids the need for taxpayer support. Westpac has developed, and maintains, a recovery plan which includes measures designed to deal with periods of financial stress. Further, Westpac will work with regulators to develop any resolution plans which may be required. Measures are also being developed to strengthen the resolution powers of Australia’s regulators.

Westpac supports the development of a sound resolution framework in Australia, and will work closely with regulators to develop this framework in a manner which is appropriate for Australia’s financial system.

5.3.5 Ring-fencing

The Inquiry has identified several major jurisdictions which are implementing bank structural reform, and specifically ‘ring-fencing.’ This is designed to protect the essential banking services and customers of those services from the riskier activities of large banking groups. The Inquiry has also acknowledged that the investment banking activities of Australia’s large banks represent a much smaller proportion of overall banking business in comparison to other large banks in those jurisdictions.

As noted in the Interim Report, ring-fencing is likely to be the most burdensome of the options to further address TBTF.⁸⁶ Westpac believes it would impose significant costs and inefficiencies on the Australian financial system and its customers.

There are a number of factors that indicate such structural reform measures are unnecessary and, indeed, unjustifiable on a cost-benefit basis:

- The relatively immaterial scale of investment banking activities by Australia’s large banks, and Australian banks’ low discretionary investment portfolios;
- The extensive additional regulatory reforms targeting such activities; and
- APRA’s supervisory approach to conglomerate banking groups.

Ring-fencing arrangements are typically considered in the structural separation of traditional consumer and commercial businesses versus investment banking, and proprietary investment. The scale of investment banking and proprietary investment in Australia’s major banks is relatively immaterial. Elements of banking business affected by market-risk in Australia, such as hedging of interest rate risk, are closely connected to the banking of commercial and corporate customers. If these elements were ring-fenced in Australia’s circumstances, it would likely lead to significant complexity for customers who currently seek to conduct their primary business, and any hedging arrangements, through a single institutional touch-point.

Further, the discretionary investment portfolios of Australian banks are low by international standards, primarily due to Australia’s reliance on international capital. This is one of the important differentiators of Australian banks compared with international peers in the context of the need for ring-fencing arrangements.

The deposits raised by the Australian financial system are insufficient to support Australian appetite for credit, and consequently Australian bank deposit to loan ratios are low by international standards, as illustrated in Figure 23.

⁸⁶ FSI Interim Report, at p.3-19

Figure 23. Comparisons of bank deposit to loan ratios⁸⁷

Bank	Deposit to Loan
State Street	1429%
JPM	169%
Morgan Stanley	149%
Citigroup	143%
Mitsubishi UFJFG	143%
Deutsche Bank	139%
HSBC	137%
UBS	137%
Standard Chartered	133%
Wells Fargo	128%
CS	123%
DBS	119%
Bank of America	115%
RBS	106%
Barclays	100%
Societe General	96%
BNP Paribas	94%
Santander	92%
Credit Agricole	89%
GS	81%
Groupe BPCE	79%
RBC	75%
Westpac	69%

In a bank with a deposit to loan ratio above 100%, interest-earning investments need to be found for the additional funding, and these are typically discretionary in nature. If international jurisdictions elect to ring-fence this activity, it is to ensure that depositors are protected from losses incurred by bad investment choices made by their banks.

In Australia, there is no excess of deposits, and therefore banks do not have discretionary investment portfolios of meaningful size that would create a need for ring-fencing arrangements.

⁸⁷ Westpac analysis, August 2014

Moreover, several other limbs of the regulatory reform agenda are separately dealing with riskier elements of banking business, including through enhanced prudential requirements, which consequently further de-risk these aspects of banking business. Examples include the fundamental review of the trading book and enhanced OTC derivative reforms.

Another pertinent domestic circumstance is APRA's more intensive approach to supervision, which includes an active focus on banks' business mix and the risk management of these activities. APRA's approach is group wide and is being further extended through development of a prudential framework for the supervision of financial conglomerates (Level 3 framework). This framework is specifically designed to ensure that the capital adequacy and risk management arrangements of a diverse banking group are sufficient to recognise and mitigate the risks of the broader group activities, including the non-APRA regulated business activities.

In the discussion of bank structural reform, it has also been suggested that introducing a requirement to establish a holding company at the head of a large banking group may facilitate a more streamlined bank resolution process for regulators. Implementing a holding company structure would be an extremely complex and costly exercise. Further, such structural adjustments would reduce the efficiency of banking groups due to the potential duplication of administration and support functions and, potentially, the requirement for standalone capital, liquidity and funding arrangements.

Indeed, many of the outcomes sought through such structural reform are already contemplated through the recovery and resolution planning processes which Australian banks are undertaking, but in a way that does not impose immediate and ongoing costs, or inefficiencies, on the financial system.

Further, it would be inappropriate to require significant re-structuring of banks in Australia simply to facilitate an easier path to resolution and 'bail-in'. Such an outcome would mean the imposition of an inefficiency burden on the Australian financial system, and hence the economy, purely to accommodate the unlikely possibility that a bank may fail at some time in the future.

In summary, there is a current lack of justification for costly and inefficient ring fencing or like measures, evidenced by:

- the modest scale of Australian banks' investment banking activities and limited bank discretionary investment portfolios; and
- broader regulatory risk-mitigation measures, underpinned by APRA's intensive supervisory approach.

These factors should also ensure that such structural reform remains unnecessary in the future.

5.3.6 Stress-testing

The prominence of bank stress tests has increased significantly since the GFC, and is a particular focus of bank capital adequacy assessments in certain jurisdictions, most notably the US. Westpac undertakes regular formal stress testing under the direction of APRA.

Stress testing is a very important element of the regulatory capital adequacy assessment process in Australia. The continued development of the regulatory reform agenda would likely see the prominence of stress testing increase even further, particularly in contributing to the resolution planning process, and in informing the determination of the need for GLAC in the Australian banking system.

Westpac recommends the increased use of stress testing as a sound means of assessing the strength of Australia's banking system and the need for any additional regulatory and prudential measures to deal with TBTF.

5.4 TBTF - Conclusion

Measures to deal with TBTF necessarily involve uncertainty, complexity and balance. Policy-makers around the world continue to grapple with these various issues to reach a point where financial systems can operate efficiently and support the growth of nations, while managing moral hazard risk.

Westpac strongly supports the principle that government intervention in the financial system in a crisis should occur in a way that minimises the risk that taxpayers are called on to 'bail out' a bank. Westpac believes that the current strength of Australian banks, and the intensity and effectiveness of prudential supervision, mean that this principle is already supported in practice.

Any further policy options to address the issue of TBTF need to be justified on the basis that there is an additional, unknown vulnerability in Australia's financial system beyond that which is contemplated in existing stability settings. There is no clear evidence of this. Further, there is no evidence of market-based pressure from international investors for Australia to implement idiosyncratic measures to further address TBTF.

Further policy options to address the issue of TBTF should also appropriately reflect Australia's circumstances, and balance the objectives of efficiency and growth. This is best achieved through close coordination of Government, regulators and the banking industry, and with an overarching objective that Australia not be placed at an international disadvantage.

While managing the risk of TBTF is unquestionably important, required measures should also align with the financial system's capacity to support the economic activity of customers and the growth of the nation.

5.5 Other Policy Options

5.5.1 The Financial Claims Scheme (3-18)

- No change to current arrangements.
- Modify the FCS, possibly including simplification, lowering the insured threshold or introducing an ex ante fee.

Westpac supports the continuation of the FCS as a post-funded scheme. Westpac does not believe that the FCS should be pre-funded.

Due to high loan to deposit ratios in Australia, local depositors are well covered by high quality assets (largely residential mortgages). In the event of bank failure, it is likely that wholesale debt financiers will be most at risk of loss. Australia's deposit preference regime also protects depositors in the event of bank failure.

Furthermore, any pre-funded levy for the FCS would need to consider the risk of moral hazard and the potential for risk-based pricing. It would also be an additional cost on banks that is likely to be passed on to depositors. This would erode customer savings and further reduce the attractiveness of bank deposits relative to other classes of assets.

5.5.2 Assessing the prudential perimeter (3-29)

- No change to current arrangements.
- Establish a mechanism, such as designation by the relevant Minister on advice from the RBA or CFR, to adjust the prudential perimeter to apply heightened regulatory and supervisory intensity to institutions or activities that pose systemic risks.

Westpac supports an enhanced mechanism for dealing with emerging systemic risks. This could occur through Ministerial designation. Such a mechanism would appropriately respond to significant likely change in the financial services sector, resulting from technological developments and new business models emerging to compete in different parts of the value chain. The prudential perimeter should have the flexibility to accommodate this new world.

To provide a level of accountability to such a mechanism, the exercise of the Ministerial designation should be subject to a 'sunset' arrangement, meaning that the designation would be required to be legislated within a reasonable period of time to maintain its validity.

5.5.3 Additional macro-prudential powers (3-30)

- No change to current arrangements.
- Introduce specific macroprudential policy tools.

Westpac believes that the existing toolkit available to APRA and the RBA is appropriate for macro-prudential supervision. The use of further macro-prudential tools can have unintended consequences and their effectiveness remains unproven. These unintended consequences, such as impacts on the allocation of resources, economic activity, growth and efficient financial sector development, have been referred to by the International Monetary Fund.⁸⁸

5.5.4 Calibrating the prudential framework (3-41)

- No change to current arrangements.
- Maintain the current calibration of Australia's prudential framework.
- Calibrate Australia's prudential framework, in aggregate, to be more conservative than the global median. This does not mean that all individual aspects of the framework need to be more conservative.

Westpac believes Australia's prudential framework is already conservative. This is discussed in detail earlier in this Chapter in the context of TBTF and moral hazard. The prudential framework should continue to be tailored to Australia's particular circumstances, and acknowledge that conservative settings can involve trade-offs with other financial system objectives, such as growth.

Therefore, Westpac supports the existing approach to the prudential framework and does not see the need for further adjustment to its calibration.

5.5.5 International comparability of Australia's prudential requirements (3-42)

- No change to current arrangements.
- Develop public reporting of regulator-endorsed internationally harmonised capital ratios with the specific objective of improving transparency.
- Adopt an approach to calculating prudential ratios with a minimum of national discretion and calibrate system safety through the setting of headline requirements.

Westpac supports public reporting of regulator-endorsed internationally harmonised capital ratios. In addition to enhancing transparency, public reporting would significantly improve consistency and comparability of bank capital levels. A genuinely harmonised capital ratio template would greatly assist in representing the true comparative position of Australian banks' capital ratios relative to international peers.

The important feature of such a template would be that it is 'regulator-endorsed.' This endorsement should occur at the Basel Committee level, so that all Basel III banks are required to produce the same harmonised report. This requirement could be readily incorporated within existing Pillar 3 reports.

⁸⁸ International Monetary Fund, *Macro-Prudential Policies to Mitigate Financial System Vulnerabilities*, August 2014.

Westpac believes there are benefits to a prudential capital framework which is purely Basel III harmonised, and which appropriately calibrates institutional and system safety, and resilience, through higher headline capital requirements. Such an approach would eliminate the challenge Australian banks face in explaining the 'real' capital position to investors in international markets.

5.5.6 Corporate governance (3-48)

- No change to current arrangements.
- Review prudential requirements on boards to ensure they do not draw boards into operational matters.
- Regulators continue to clarify their expectations on the role of boards.

Westpac agrees with the Inquiry's observation that good corporate governance involves clear and distinct duties performed by the board and senior management and that regulation should not alter that delineation of responsibilities.

Westpac notes the commentary regarding regulatory requirements being too prescriptive and not respecting the appropriate division between the responsibilities of the board and those of management. The risk in such a trend is that it could result in board resources being focused on specific regulatory requests relating to management functions, with fewer resources available to undertake the traditional board roles of overseeing management and considering company strategy.

Westpac values the importance of maintaining high corporate governance standards and therefore supports the benefits of a review of prudential requirements on boards to ensure they are not drawn unnecessarily, or inappropriately, into operational matters.

Chapter 6 – Consumer Outcomes

Westpac Key Issues and Insights

Disclosure

- The financial system's current disclosure regime has led to increased costs and, in many instances, voluminous documentation that does not enhance customer understanding.
- Notwithstanding these concerns, Westpac believes disclosure should remain the fundamental foundation of consumer protection in Australia's financial system. As an overarching principle, regulation of financial products should provide effective consumer protection while continuing to allow consumers to take risk.
- Westpac believes it is important that the current disclosure regime is improved to provide accessible information to consumers, which supports informed choice within a statutory framework of product suitability, and a regulatory oversight framework.
- To this end, Westpac believes Government and regulators should undertake a review of disclosure with industry and other stakeholders, to design more consumer-friendly documents based on applied research.
- Such an approach is preferable to more interventionist regulation that inhibits innovation, for example, further regulation of product design or distribution.

Financial advice

- Affordable, professional and quality financial advice is also vital to ensuring beneficial financial outcomes for individual consumers. Improving the training and capabilities of those who provide advice is essential to maintain trust and deliver positive consumer outcomes.
- Westpac supports significantly raising education and professional standards, and establishing a public register for financial advisers as means to improve quality and transparency in the industry.
- A new national competency framework, overseen by a new Self-Regulatory Organisation, is required to begin to place financial advisers on a similar professional footing to lawyers and accountants.
- Westpac believes there is potential to improve consumer understanding by more clearly labelling what is today termed 'General Advice' to 'General Financial Information,' and more explicitly limiting who can hold themselves out to be a 'financial adviser'.
- However, Westpac does not support the introduction of regulatory distinctions between different business models or advisers, on the grounds that such labels are not meaningful and may be misleading if incorrectly interpreted by consumers.
- One of the key strengths of the Australian regulatory system emerging from the introduction of the FoFA laws is that any person who provides personal financial advice to retail clients must act in the best interests of the client. This means that all advisers who provide personal advice to retail clients, regardless of their business model or nomenclature, owe the same legal duty to act in the best interests of their clients. It also means they are subject to the same restrictions with respect to permissible forms of remuneration.

Chapter 6 – Consumer Outcomes

Westpac's Initial Submission discussed the importance of consumer protection as an essential goal of financial regulation, and the need for Australia's regulatory framework to be appropriately balanced to ensure financial innovation can continue to flourish.

Within this backdrop, Westpac's response to the Interim Report's observations in the Consumer Outcomes chapter focuses on issues regarding disclosure.

Westpac also addresses the other policy options raised by the Interim Report in the Consumer Outcomes chapter.

6.1 Disclosure (3-62)

- No change to current arrangements.
- Improve the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators.
- Remove disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using technology and electronic delivery.
- Subject product issuers to a range of product design requirements, such as targeted regulation of product features and distribution requirements to promote provision of suitable products to consumers.
- Provide ASIC with additional powers such as:
 - Product intervention powers to prescribe marketing terminology for complex or more risky products.
 - A power to temporarily ban products where there is significant likelihood of detriment to consumers.
- Consider a move towards more default products with simple features and fee structures.

As discussed in Westpac's Initial Submission, Westpac supports measures for the modernisation and consistency of product disclosure requirements,⁸⁹ and in particular enhancements to the regulatory framework that would facilitate greater use of electronic communication to provide information to consumers.⁹⁰

Westpac agrees with the observation in the Interim Report that:

*'[t]he current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.'*⁹¹

These documents are the result of prescriptive regulatory requirements that encourage a tick-the-box mentality towards compliance by financial products and services providers.

⁸⁹ Westpac, Initial Submission to the Financial System Inquiry, at p.101

⁹⁰ Ibid, at p. 92

⁹¹ FSI interim report, at p. 3-56

Notwithstanding these concerns, disclosure will and should remain the fundamental foundation of Australia's financial services consumer protection system. Providing information to consumers that enables them to make informed decisions can achieve effective consumer protection outcomes without the need for more interventionist regulation.

The acknowledged issues with disclosure suggest changes are necessary to ensure that disclosure documents provide information that consumers can understand. Research in the field of behavioural economics shows the effect that framing of information can have on consumer decision making. This highlights the need for disclosure documents to be 'road tested'.

Westpac believes that fully assessing the effectiveness of various forms of disclosure across the full range of consumer financial products is a task that would extend beyond the scope of the Inquiry. Westpac suggests that the Inquiry's final report include a recommendation that:

- the Government and regulators undertake a review of disclosure with industry and other stakeholders, to design more consumer-friendly disclosure documents based on applied research; and
- this review should consider in more detail the options for disclosure proposed in the Interim Report including layered disclosure and risk profile disclosure.

The Interim Report also suggests that disclosure alone is not sufficient to protect consumers from harm and contemplates whether further measures are necessary. These potential measures include regulation of financial product features, default product design, suitability of financial products and product intervention powers. They are each addressed below.

A number of specific concerns which have emerged in relation to financial products and services following the GFC have already been addressed through regulation, including:

- the National Consumer Credit Protection regime;
- regulation of margin lending; and
- FoFA reforms.

As an overarching principle, regulation of financial products should provide effective consumer protection while continuing to allow consumers to take risk. Risk is an inherent feature of financial products. Financial loss is not by itself evidence of an error in consumer decision making or a flaw in a financial product.

To continue to allow risk, Westpac believes it is important that regulation does not inhibit product innovation or informed consumer choice. Instead, providers should operate in a principles-based regulatory environment with a statutory framework of product suitability, with regulators having appropriate oversight to enable issues to be quickly identified and addressed when they emerge.

6.1.1 Regulation of financial product features

The regulation of specific product features is always an option available to Government. For example, in 2011, the Government regulated to ban mortgage exit fees. However, regulation of product features is a highly interventionist approach. It has the potential to reduce competition, reduce consumer choice and inhibit innovation. It is also likely that unscrupulous operators in the industry will find loopholes to continue to exploit unsophisticated consumers. It will never be a substitute for effective enforcement and regulatory oversight.

Westpac supports specific regulation of financial product features only where evidence of consumer harm has been established, and thorough cost-benefit assessment shows that it is the best option to prevent that harm.

6.1.2 Default product design

Regulation of default products has been adopted as part of the MySuper regime. In that case, it is appropriate due to the compulsory nature of superannuation. There is also strong evidence that superannuation savings are invested in their employer's default offering, due to consumers not indicating an alternative choice.

The application of default options would be more difficult where a consumer actively seeks a financial product. Such an approach involves government and/or regulators 'second guessing' whether consumers have made an informed choice, or whether they have made an error in their decision making.

In Westpac's view, the aim should be to allow the market to provide consumers with access to a wide range of products which may meet their needs. Regulation should ensure information is provided in an effective way which enables consumers to choose. This should be supplemented by an effective oversight and enforcement regime.

6.1.3 Suitability of financial products

As noted in the Interim Report, there are already a number of ways that the existing law provides for product suitability including:

- requiring credit providers and credit intermediaries to determine that a credit product is 'not unsuitable' for the consumer;
- imposing a 'best interests' test on financial advisers; and
- retail and wholesale investor tests.

In these instances, financial services providers are required to undertake an assessment of a consumer's financial position and needs. For example, in relation to credit products, a credit provider must determine a customer's capacity to repay as well as determining that a product is 'not unsuitable.'

Where such an assessment is not undertaken, it is difficult for financial services providers to make an assessment of product suitability. This would be the case for financial investment products which consumers can purchase directly without the need to obtain personal advice.

Where no advice or only general advice has been provided, an assessment of product suitability would need to be undertaken based on information provided in the application. This would only include readily observable factors e.g. age, income, occupation, etc. Studies have shown that, while there may be an association between socio-economic factors and average levels of financial literacy, within a particular demographic group financial literacy will vary widely.⁹² These factors would therefore not be firm indicators of tolerance, or ability, to take on financial risk.

As indicated above, Westpac would support the consideration of risk profile disclosure for products. This could help a consumer determine whether a particular product meets his or her risk profile. This should be considered as part of the assessment of disclosure, and could be supplemented by tools to assist consumers to determine their risk profile.

An additional issue that should be addressed is the definition of retail and wholesale investors. This is not raised as an option in the Interim Report, but was considered by the recent Senate Economics Committee's Inquiry into the Performance of ASIC. Westpac would support recommendations 59 and 60 of the Committee's report.⁹³ Clearer definitions of retail and wholesale investors would ensure that any changes to the regulatory regime can be directed at those investors who need protection.

6.1.4 Product intervention powers

The Interim Report has sought views on whether ASIC should be provided with additional powers to address specific issues. As highlighted elsewhere in this Second Submission and Westpac's Initial Submission, Westpac believes aspects of the current consumer protection regulatory regime should be reviewed (for example, in relation to disclosure). ASIC's powers should be assessed in light of any changes that are made in these areas. At an overall level, however, Westpac believes ASIC has a wide range of powers to address specific issues under the current law, including powers to make stop orders, powers to make administrative banning orders and powers to issue infringement notices. Through this wide range of powers, ASIC has the ability to take steps to ensure that a financial services licensee acts fairly, efficiently and honestly.

If the Inquiry determines that ASIC's consumer protection powers in relation to product intervention should be expanded, these tools should be focused on circumstances where there is a clear, pressing consumer protection concern. Any additional powers must be subject to appropriate limits. For example, powers to temporarily ban products could have a significant impact on customers of an affected financial services provider (if the product itself is a listed, traded security for example) as well as creating an uncertain environment for providers, which could potentially reduce innovation and investment.

Such a ban should only have effect for a short period to enable ASIC to seek further information and assess the level of consumer risk. Beyond the temporary period, an extension to a product ban should require an application to the court.

⁹² ANZ. *Survey of Adult Financial Literacy in Australia*, at p. 1

⁹³ Senate Economics Committee report p 443

6.2 Other policy options

6.2.1 Financial advice (3-69)

- No change to current arrangements.
- Raise minimum education and competency standards for personal advice (including particular standards for more complex products or structures, such as SMSFs) and introduce a national examination for financial advisers providing personal advice.
- Introduce an enhanced public register of financial advisers (including employee advisers) which includes a record of each adviser's credentials and current status in the industry, managed either by Government or industry.
- Enhance ASIC's power to include banning individuals from managing a financial services business.

a. Education/competency

Westpac supports significantly raising minimum entry and ongoing education and competency standards across the industry. The present requirements for financial advisers are inadequate compared to other professions.

A new national competency framework is required to begin to place financial advisers on a similar professional footing to lawyers and accountants.

Following the establishment of this framework, Westpac recommends that, within five years, all new and existing financial advisers should be required to hold at least one of the following qualifications/designations:

- Certified Financial Planner;
- Fellow Chartered Financial Practitioner; or
- Appropriate financial planning certification from one of the recognised accounting bodies.

These requirements must be supported by a robust Continuing Professional Development framework which includes compulsory ethics training. Finally, membership of a genuine professional body should also be a condition of being able to be called a financial adviser.

As outlined in Westpac's Initial Submission, this national competency framework should be established and overseen by a new Self-Regulatory Organisation (SRO). The SRO would be a non-profit independently governed organisation that would develop a comprehensive framework encompassing admission requirements, initial and ongoing technical and ethical standards, and training requirements.

This SRO would also centralise various existing training and competency requirements – such as those applicable to financial advisers under the Tax Agent Services regime.

The SRO would be funded by the profession and delegated authority under the *Corporations Act 2001* to perform its role. This delegation would ensure that membership of the SRO is compulsory and its standards binding. It would be accountable for delivering on its objectives – particularly in the area of professional standards – to ASIC and ultimately the Parliament.

b. Public Register

Westpac strongly supports the development of a public register of financial advisers as another measure to increase transparency for consumers.

It is vital that all Australians should have access to as much relevant information as possible to make an informed choice about the best financial adviser available. This register should encompass education, years of experience, employment history, areas of expertise and annual certification results for every financial planner in Australia. Any certification process should be underpinned by a common industry audit standard to ensure consistency.

c. ASIC powers

Westpac supports the expansion of ASIC powers to include the ability to ban an individual from operating a financial services business, consistent with the recent recommendation in the Senate References Committee, Performance of the Australian Securities and Investments Commission, June 2014 Report.

6.2.2 Accessibility of advice (3-72)

What opportunities exist for enhancing consumer access to low-cost, effective advice?

- What opportunities are there for using technology to deliver advice services and what are the regulatory impediments, if any, to those being realised?
- What are the potential costs or risks of this form of financial advice, and what measures could be taken to mitigate any risks?

a. Scalable advice

Westpac welcomes the Interim Report's focus on facilitating the provision of scalable advice. As identified in the Interim Report, consumers have consistently expressed their preference to obtain financial advice in a range of formats and across a variety of single subjects.

Recent consumer testing conducted for the ABA and FSC by Roy Morgan found that there is a significant gap between what consumers expect to pay for advice and what it actually costs to provide advice. Specifically, the research found 75% of consumers expect a comprehensive financial plan to cost under \$1,000, with less than 10% willing to pay the actual cost of a comprehensive financial plan (typically around \$2,500).⁹⁴

The need to bridge this gap is further supported by consumers expressing a strong desire to have the ability to control the scope of the advice they receive from their financial planner. When asked, 87% of consumers agreed that it should be within their rights to be able to specify the type and scope of financial advice they receive from a financial planner.

⁹⁴ Roy Morgan, Financial Advice Survey, 2014

Importantly, Westpac believes the final form of the FoFA reforms will enable the provision of scalable advice within the bounds of a robust regulatory regime. Specifically, the Government's recent change to allow the client and the adviser to agree to the scope of the advice is central to the ability of providers to confidently offer more targeted and affordable advice that meets their client's best interests.

Westpac supports these changes and believes they will allow providers to innovate and deliver better targeted and more cost-effective advice.

b. Facilitating the use of technology in the provision of advice

Facilitating the use of technology in the provision of advice has the capacity to support the Inquiry's objectives of increasing the accessibility of quality advice at a lower cost.

While using technology to make advisers more accessible through a variety of communications (phone, live chat, and video conferencing) is already occurring, there is an even greater potential for technology to provide completely automated personal advice solutions over the internet or through mobile applications and devices at a much lower cost.

These solutions would leverage input directly provided by the end consumer and/or existing information that the organisation holds about the individual. They would use an expert system to combine the personal data with standard advice strategies, to deliver personal advice recommendations and solutions.

While technologically possible, there are numerous regulatory impediments to this type of advice emerging:

- To comply with the best interest duty under the FoFA provisions, an individual person must be involved with or be responsible for the advice. This is because elements of the test (or the safe harbour provisions) are impossible to comply with as a computer program. For example, a computer program will not be able to determine if information is inaccurate or incomplete.⁹⁵ It is therefore unclear how this form of advice would comply with existing provisions;
- Although ASIC has reiterated its earlier position that the Corporations Act is generally neutral about which method is used to deliver advice, ASIC has stated that it will regulate advice in the same way regardless of the method used. However, this guidance is provided in the context of delivering traditional advice across different channels (i.e. phone, live chat, video conferencing etc.);
- Under RG146, individuals who provide financial advice to retail clients must meet certain minimum knowledge and training qualifications and standards. How would a fully systematised personal advice solution fit into this model; and

⁹⁵ Section 961B(2)(c) requires the provider to do the following: "where it was reasonably apparent that information relating to the client's relevant circumstances was incomplete or inaccurate, made reasonable inquiries to obtain complete and accurate information."

- ASIC has previously raised concerns with what it considers ‘template’ advice. A fully algorithmic (expert system) solution may be perceived in this way despite the substantial enhancements available in the modelling and analytical capabilities that will be possible to deliver highly personalised solutions.

Given the complexity of these issues and to support innovation, there is a need to explicitly deal with these matters through a separate regulatory framework rather than simply issuing general guidance in the context of the existing provisions.

6.2.3 Independent versus aligned advisers (3-73)

- Is there is a case to more clearly distinguish between independent and aligned advisers, and what options exist for doing this?
- Would consumers be likely to understand the difference between aligned and independent advisers and, if so, to what extent would this be likely to factor into a consumer’s decision to take the advice?
- Would consumers be likely to be sensitive to differences in the price of independent or aligned advice?

The potential to improve consumer understanding by more clearly labelling what is today termed ‘General Advice,’ and the question of who can hold themselves out to be a ‘financial adviser’ are dealt with in Section 6.2.4.

Beyond those changes, Westpac has a range of concerns with segmenting advisers depending on their ownership structure or business model.

The term ‘independent’ is already a restricted word under s923B of the Corporations Act. This means that a person who carries on a financial services business cannot use the term, unless that person (or the person’s employer, licensee or associate):

- does not receive commissions, volume based product payments or gifts or benefits from a product issuer that may reasonably be expected to influence the person; and
- is not restricted in relation to the financial products it can recommend to clients and has no conflicts of interest in relation to product issuers.

It is appropriate that the word ‘independent’ remains restricted and continues to operate as is currently the case.

Westpac does not support the introduction of any additional regulatory distinctions between different business models or advisers on the grounds that such labels are not meaningful and may be misleading if incorrectly interpreted by consumers.

One of the key strengths of the Australian regulatory system emerging from the introduction of the FoFA reforms is that any person who provides personal financial advice to retail clients must act in the best interests of the client. This means that all advisers who provide personal advice to retail clients, regardless of their business model or nomenclature, owe the same legal duty to act in the best interests of their clients and give priority to their clients’ interests ahead of their own. It also means they are subject to the same restrictions with respect to permissible forms of remuneration.

One of the most important outcomes of the FoFA reforms is that they will neutralise the conflicts of interests that were traditionally perceived to exist in aligned advice licensees, and this will continue to strengthen over time when grandfathered benefits eventually become obsolete.

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. Westpac therefore supports further transparency in this area to make it abundantly clear under what license an adviser is operating and who the owner of that license is. As outlined above, this is also a matter that should be incorporated into the Public Register.

Irrespective of whether these matters are clear to consumers, under our regulatory regime an 'aligned' adviser must act no differently to someone that meets the definition of an 'independent' adviser. In fact, there are undoubtedly circumstances where aligned advisers survey a wider array of financial products in the market than non-aligned advisers simply because they have the institutional resources (via research departments) to assess and monitor a greater number of financial products.

While this will not always be the case, it highlights the risks of a simplistic distinction based on business model or ownership of the licence.

In any event, the ability of any adviser to be truly 'unrestricted' (as distinct from 'independent') in the advice they provide should be queried. It is simply not possible for a financial adviser to survey the entire market. This is true of 'aligned' and 'independent' advisers. This is as much due to the number of financial products in existence as it is to being able to obtain personal indemnity insurance – a requirement of maintaining a licence.

ASIC figures show that in 2013 there were over 4,100 Registered Managed Investment Schemes (managed funds).⁹⁶ Even the most open-architecture investment platform used by an 'independent adviser' would be unlikely to exceed 1,000 investment options.

⁹⁶ FSC, State of the Industry Report, 2013.

As a consequence, any business model or product-based distinctions are irrelevant at best and misleading at worst. While it may be informative in terms of market analysis and understanding business model trends, it is meaningless in terms of its description of an individual adviser's flexibility to provide advice across a range of subject areas and financial products. It is also potentially misleading by creating the implication that one type of adviser owes a higher legal duty than another – depending on their business model.

Beyond the present limitations on the term 'independent', there is very little policy basis domestically for drawing a legislative distinction between restricted and so-called unrestricted advisers. Additionally, before considering the adoption of such an approach the Inquiry should carefully consider the UK experience where a similar distinction was drawn as part of their Retail Distribution Reforms.

In the UK, most major institutions have significantly pulled back from the advice market giving rise to a substantial 'advice gap.' At the same time, the market has been significantly skewed away from 'independent' and towards 'restricted' models.⁹⁷

As a consequence of the reforms, market research has identified that an investor who has less than £61,000 (\$110,000) to invest is no longer commercially viable to service. Not surprisingly, 75% of the UK's adult population does not have current investible assets above this level.⁹⁸

While this highlights the failure of the UK regime, it also supports the need for a variety of advice models and different forms of advice being supported by the regulatory regime.

Westpac therefore does not support the UK model being replicated in Australia. Rather, Australia is better served by retaining the existing highly robust regulatory regime that does not distinguish based on ownership structure, and instead requires all providers of personal advice to meet the same regulatory requirements. This principle extends to not only the ownership structure of the licensee but also the nature of the individual involved – whether they be an accountant, adviser or known by some other title.

Australia's advice regulatory model has now been independently assessed by Deloitte against several other regimes including the UK. Their analysis found that after taking into account the Government's recent proposals, Australia will have a higher standard of regulation with more prescriptive requirements than comparable advanced economies like Canada, Hong Kong, Singapore, the United Kingdom and the United States.⁹⁹

Westpac, therefore, does not see the need for further changes to the recently finalised future of financial advice laws.

6.2.4 General advice (3-74)

- No change to current arrangements
- Rename general advice as 'sales' or 'product information' and mandate that the term 'advice' can only be used in relation to personal advice.

⁹⁷ CFA Institute, *Restricting Sales Inducements - Perspectives on the Availability and Quality of Financial Advice for Individual Investors*, 2013

⁹⁸ <http://www.cass.city.ac.uk/news-and-events/news/2013/january/fidelity-story-final>

⁹⁹ Deloitte, *A comparison of financial advice regulations – personal advice for retail clients*, 2014

a. Re-labelling General Advice

Westpac agrees there is a need to re-evaluate financial advice terminology contained in the Corporations Act. In particular, the current delineation between factual information, General Advice and Personal Advice can be confusing regarding the true nature of General Advice.

In the context of the recent FoFA debate, it was clear that there was a significant misunderstanding of the breadth of General Advice. As correctly outlined in the Interim Report, General Advice – by definition – cannot take into account a client's personal circumstances or needs. Westpac strongly supports this distinction. The distinction works in consumers' favour. It ensures that the test of whether a client's personal circumstances or needs have been taken into account is determined by whether it is reasonable for the consumer to believe that his/her circumstances were taken into account.

As a result, it is difficult to imagine why a provider would deliberately seek to mislead consumers into believing they are receiving Personal Advice. By definition, if the consumer believes they are receiving Personal Advice, then the applicable consumer protections are extended to them. Nevertheless, given concerns that consumers may misinterpret the information being provided as something more than merely General Advice, Westpac supports consideration of a clearer distinction being drawn via different terminology.

The provision of General Advice occurs across a variety of service models ranging from scripted client assistance, one-to-one conversations, newsletters, internet material and client educational seminars.

As a result, Westpac does not support the introduction of terminology based around 'sales'. Much of the information provided via 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.

Instead, Westpac suggests that General Advice be renamed General Financial Information. This 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.

b. 'Limiting the term 'Financial Adviser''

Given the distinction above, the term 'Financial Adviser' would be restricted to those who provide Personal Advice and who meet the relevant training and competency standards to provide personal advice established by a new SRO funded by the profession and delegated authority under the Corporations Act 2001.

Individuals who either do not provide Personal Advice, or who do not meet the relevant training and competency standards, would be unable to hold themselves out as Financial Advisers.

This would strengthen the distinction drawn above by clearly labelling the title of the individual providing the information, and ensuring only a qualified and authorised individual is able to hold themselves out as being a financial adviser.

6.2.5 Regulatory framework for managed investment schemes (3-85)

- No change to current arrangements.
- Amend the existing regulatory framework for managed investment schemes.

Westpac does not believe there is a need to amend the current regulatory framework applying to managed investment schemes. While there may be scope to improve certain aspects of the current regime, these are likely to be relatively minor. Westpac believes the current regime is largely operating as intended.

Provided that managed investment schemes are not making any 'promise' to scheme members and remain a discretionary form of investment, there is no clear case for managed investment scheme regulation or oversight being transferred to APRA.

6.2.6 Product rationalisation of 'legacy products' (3-87)

- No change to current arrangements.
- Government to renew consideration of 2009 proposals on product rationalisation of legacy products.

In addition to Westpac's observations in section 4.2.5, Westpac's views regarding wider product rationalisation of 'legacy products' are incorporated in the FSC submission.

Chapter 7 – Regulatory Architecture

Westpac Key Issues and Insights

- The financial system’s regulatory framework is vital to the system’s ability to meet the needs of customers and to support the nation’s growth.
- In Westpac’s view, there is still much to be gained by undertaking a stocktake of the agenda for regulatory reform to evaluate the combined impact of existing and proposed regulation, particularly in light of the Inquiry’s examination of additional stability measures.
- Further, Westpac supports a proposal for periodic, legislated, independent reviews of regulatory performance and capability, and clarification of metrics for the performance of regulators.
- Westpac believes that changes to funding arrangements for regulators should consider ultimate cost increases to consumers and should only be undertaken with increased transparency and defined accountability objectives.
- Westpac also supports more formal oversight being granted to the Council of Financial Regulators.

Chapter 7 – Regulatory Architecture

Westpac believes that, fundamentally, Australia’s regulatory architecture is appropriate for our domestic circumstances. That said, the regulatory environment remains unnecessarily complex. Appendix 1 of Westpac’s Initial Submission discussed opportunities to streamline regulatory implementation in Australia, focusing on three areas:

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

It is within this context that Westpac provides responses to the Interim Report’s policy options relating to Regulatory Architecture.

7.1 Regulatory burden (3-97)

- Is there evidence to support conclusions that the regulatory burden is relatively high in Australia when considered against comparable jurisdictions?
- Are there examples where it can be demonstrated that the costs of regulation affecting the financial system are outweighing the benefits?
- Are there examples where a more tailored approach could be taken to regulation; for example, for smaller ADIs?
- Are there regulatory outcomes that could be improved, without adding to the complexity or volume of existing rules?
- Could data collection processes be streamlined?
- If new data is required, is there existing data reporting that could be dropped?
- Instead of collecting new data, could more be made of existing data, including making more of it publicly available?

Westpac refers the Inquiry to Chapter 3 and Appendix 1 of Westpac’s Initial Submission, which outlines several observations regarding the regulatory burden and opportunities to streamline regulatory implementation.

Westpac also supports the observations made in the ABA Submission on these issues.

7.2 Aligning APRA-regulated super trustees and funds with responsible entities and managed investment schemes (3-103)

- No change to current arrangements.
- Align regulation of APRA-regulated superannuation trustees and funds with responsible entities and registered management investment schemes.

Westpac supports no change to the current arrangements.

The current framework for prudential regulation of superannuation trustees is appropriate, and recognises the importance of protection of retirement savings in a compulsory environment. Removing prudential regulation of superannuation trustees has the potential to lead to a re-proliferation of smaller superannuation funds, with disaggregation and risk to the system. This could undermine the public's confidence in the superannuation system.

Failures of regulated superannuation funds have been very low compared with managed investment schemes.

The continued oversight of superannuation by APRA is even more important considering the ongoing shift from accumulation to pension which is taking place. As more Australians enter the pension phase, there will be an even greater need for appropriate prudential oversight of superannuation funds and income stream providers.

7.3 Conduct regulation: fund administrators and technology service providers (3-108)

- No change to current arrangements.
- Impose AFSL requirements for providers of fund administration and technology service of sufficient scale.
- Apply market integrity rules for licensed securities dealers that provide investor services substantially similar to market participants of a licensed financial market.
- Introduce a mechanism to allow a heightened level of regulatory intensity to be applied where risk arises outside the conduct perimeter.

7.3.1 Fund administrators

Westpac supports the need for fund administrators to be appropriately licensed.

7.3.2 Technology services

Westpac does not support the introduction of Australian Financial Services Licence requirements for providers of technology services. The introduction of these requirements would likely:

- impact commercial offerings in the market;
- hamper innovation, as there would be a disincentive to new entrants; and
- potentially capture a larger number of technology providers than currently regulated under CPS 231 Outsourcing. In Westpac's view, the requirements of CPS 231 are pragmatic and appropriate in applying only to APRA regulated entities for outsourcing arrangements involving material business activities.

A broader application of these requirements has the potential to impact on efficiency, given the scale of providers that could be brought within the framework. For example, Westpac has sourcing relationships with up to 10,000 suppliers at any given time. Westpac's experience is that our material technology providers understand the current regulatory framework, and Westpac has a policy of requiring suppliers to be contractually liable to meet the requirements of CPS 231.

7.3.3 Licensed securities dealers

Westpac does not support the application of market integrity rules to licensed securities dealers. Such a measure would create unnecessary complexity given the comprehensive burden of existing domestic and international regulation. The adequacy of prevailing regulatory enforcement powers is further evident in the recent ASIC enforcement action in response to allegations of market misconduct.

7.3.4 Heightened level of regulatory intensity

Westpac supports further consideration of a mechanism to allow a heightened level of regulatory intensity where risk arises outside the conduct perimeter. This mechanism should be based on clear, recognised criteria for regulatory intervention and its use should be transparent and accountable.

7.4 Independence (3-113)

- No change to current arrangements.
- Move ASIC and APRA to a more autonomous budget and funding process.

Any budget or funding policy option should take account of the fact that increased levies on financial system providers ultimately increase costs of financial services to consumers.

If either an industry-based funding model for ASIC or a more autonomous budget setting process for APRA were pursued, Westpac believes these options should be strongly linked to:

- a more transparent budget setting process with extensive consultation with stakeholders and final approval by the Government. For example, such a process should demonstrate forward projections of expenditure and where funds are planned to be allocated;
- a risk based-approach to regulation so that expenditure or resources are not overly directed towards areas of low regulatory risk; and
- accountability measures such as those listed in the next section.

7.5 Accountability (3-117)

- No change to current arrangements.
- Conduct periodic, legislated independent reviews of the performance and capability of regulators.
- Clarify the metrics for assessing regulatory performance.
- Enhance the role of Statements of Expectations and Statements of Intent.
- Replace the efficiency dividend with tailored budget accountability mechanisms, such as regular audits and reviews to assess the regulators' potential for savings.
- Improve the oversight processes of regulators.

As outlined in Appendix 1 of Westpac's Initial Submission, Westpac supports a proposal for periodic, legislated, independent reviews of regulatory performance, and clarification of metrics for the performance of regulators.

Westpac also considers that it would be appropriate to enhance the current model and explore the use of a Government Statement of Expectations (SOE), analogous to the model currently in place in New Zealand. This would provide a sound basis for the development of regulatory performance measures and budget setting. Any such SOE should be risk-based, recognising that it would not be efficient for regulators to seek to address all possible risks. The SOE would also better inform public expectation of regulators.

7.6 The role of the Council of Financial Regulators (3-120)

- No change to current arrangements.
- Consider increasing the role, transparency and external accountability mechanisms of the CFR:
 - Formalise the role of the CFR within statute.
 - Increase the CFR membership to include the ACCC, AUSTRAC and the ATO.
 - Increase the reporting by the CFR.

As outlined in Appendix 1 of Westpac's Initial Submission, Westpac supports more formal oversight being granted to the Council of Financial Regulators (CFR), and a regular public review of financial system regulators led by the CFR.

Westpac generally supports the view that the CFR should be a coordination agency rather than assume the powers of individual agencies. Moreover, Westpac supports the formalisation of the CFR's role within statute and increased reporting by the CFR of its activities.

In Westpac's view, there is no compelling case for membership of the CFR to be expanded.

7.7 Regulator mandates; competition considerations; Corporations Act penalty regime; attracting and retaining regulatory staff (3-128)

- No change to current arrangements.
 - Strengthen competition considerations through mechanisms other than amending regulators' mandates.
 - Refine the scope and breadth of ASIC's mandate.
 - Review the penalty regime in the Corporations Act.
 - Review mechanisms to attract and retain staff, including terms and conditions.
-
- Are changes needed to strengthen and/or refocus ASIC?
 - Is the current enforcement regime adequate? Does ASIC have adequate powers?
 - Are there alternative mechanisms for promoting better consideration of competition within financial sector regulation?

7.7.1 Strengthening competition considerations

Westpac supports the rigorous application of competition considerations in the financial sector and considers current regulatory arrangements sufficient to adequately address competition issues. As the Interim Report notes, APRA already has a specific competition mandate, and ASIC is able to consider competition issues in some circumstances, for example, in authorising the entry of Chi-X.

As Westpac outlined in Appendix 1 of its Initial Submission, consideration of competition issues may be strengthened through mechanisms other than amending regulators' mandates. Where ASIC is concerned about competition aspects in the financial sector, it has the ability to refer these matters to the ACCC for further consideration. In that regard, the existing Memorandum of Understanding between ASIC and the ACCC could be further refined to ensure that referral and cooperation between the regulators on competition-related matters is explicitly articulated.¹⁰⁰

However, extending ASIC's statutory mandate to include a competition objective may create unintended consequences, including overlaps and irreconcilable conflicts with the ACCC's jurisdiction and decision-making. ASIC has a broader mandate which includes maintaining stability and orderly markets, which inherently may involve conflict with competition laws.

Unlike some other jurisdictions, such as the United States, where such conflicts may be resolved on a case by case basis by courts, Australian competition law provides much more limited flexibility.

Westpac considers that competition issues should continue to be considered within the ambit of the ACCC, which has the expertise and focus to address competition-specific concerns. Through its authorisation process, the ACCC may also consider public benefits other than competition in considering whether to authorise action, notwithstanding potential anti-competitive effects.

¹⁰⁰ Memorandum of Understanding between ASIC and the ACCC, 15 December 2004.

7.7.2 Enforcement regime

Westpac believes ASIC's current enforcement regime is adequate and includes a comprehensive set of measures including:

- very broad investigation and surveillance powers;
- significant consumer protection powers analogous to those available to the ACCC;
- the ability to use both civil and criminal remedies in particular cases; and
- banning powers, to ensure that the industry is protected from individual wrongdoers.

The refocusing of regulatory activity towards the area of greatest harm, along with a clear set of measures, would most effectively maximise ASIC's performance.

Chapter 8 – Retirement Income

Westpac Key Issues and Insights

- Westpac believes the retirement income system should aim to deliver a level of income replacement in retirement of up to 65% to 70% for the majority of Australians.
- In doing so the system should also substantially offset the cost of the Age Pension by ensuring Australians can self-fund their retirement to the maximum extent possible.
- Westpac does not support the suggestion that the purchase of a specific income stream (of any type) at retirement should be made compulsory.
- Westpac also believes default models risk entrenching further disengagement and, in doing so, reduce competition and result in lower retirement incomes for members. To counter this, any default system should be principles-based and supported by an integrated advice model which provides targeted, simple advice to members to ensure that the default is properly calibrated.
- Westpac supports the creation of policy incentives to encourage the take-up of an appropriate retirement income stream, enabling individuals to select from a range of products that could meet their needs.
- Westpac is proposing consideration of a retirement income model which includes a combination of a flexible default income stream coupled with appropriate policy incentives. The model centres on incentivising as many Australians as possible to provide a minimum level of income up to the value of the Age Pension for the duration of their retirement. It would still be possible for small balances to remain in the default (or select from other products) without penalty.
- The model would encourage innovation in best delivering an income stream that achieves the stated objectives. Individuals could then choose from a range of products and providers which meet the above requirements or remain in their provider's default.
- Compared with the present system, this framework will help to ensure that the fiscal objective of superannuation is met.

Chapter 8 – Retirement Income

Westpac believes that more should be done to reinforce the objective of the superannuation system to deliver up to 65% to 70% of income replacement in retirement for all Australians.

In doing so, the system should also substantially offset the cost of the age pension by making sure Australians can self-fund their retirement to the maximum extent possible, and for the complete duration of their lives.

Relevant policy settings should reinforce these objectives. Westpac therefore acknowledges the Tax White Paper process as an additional opportunity to examine wider tax and social security settings, to ensure that there is a coherent and holistic approach to retirement incomes policy.

8.1 Retirement income policy options (4-25)

A spectrum of options to achieve the objectives of the retirement income system and position Australia to manage the challenges of having an ageing population:

- Maintain the status quo with improved provision of financial advice and removal of impediments to product development.
- Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.
- Introduce a default option for how individuals take their retirement benefits.
- Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).

8.1.1 Purpose of the superannuation system

As outlined in Westpac's Initial Submission, the appropriate policy response in retirement depends on the overarching purpose of the superannuation system – both from a member perspective and a fiscal policy perspective.

From a member perspective, Westpac believes the system should aim to deliver a level of income replacement in retirement of up to 65% to 70% for all Australians. The system's settings should support this objective.

From a fiscal policy perspective, the system should be designed to substantially offset the cost of the age pension by making sure Australians can self-fund their retirement to the maximum extent possible, and for the complete duration of their lives. This objective recognises that not every Australian will be in a position to completely self-fund their retirement, and therefore there will always be a role for the Age Pension.

8.1.2 Consideration of Policy Settings

In considering the development of appropriate retirement income policy settings, it is necessary to recognise that not all Australians have had the benefit of compulsory superannuation (at meaningful levels) for the majority of their working lives.

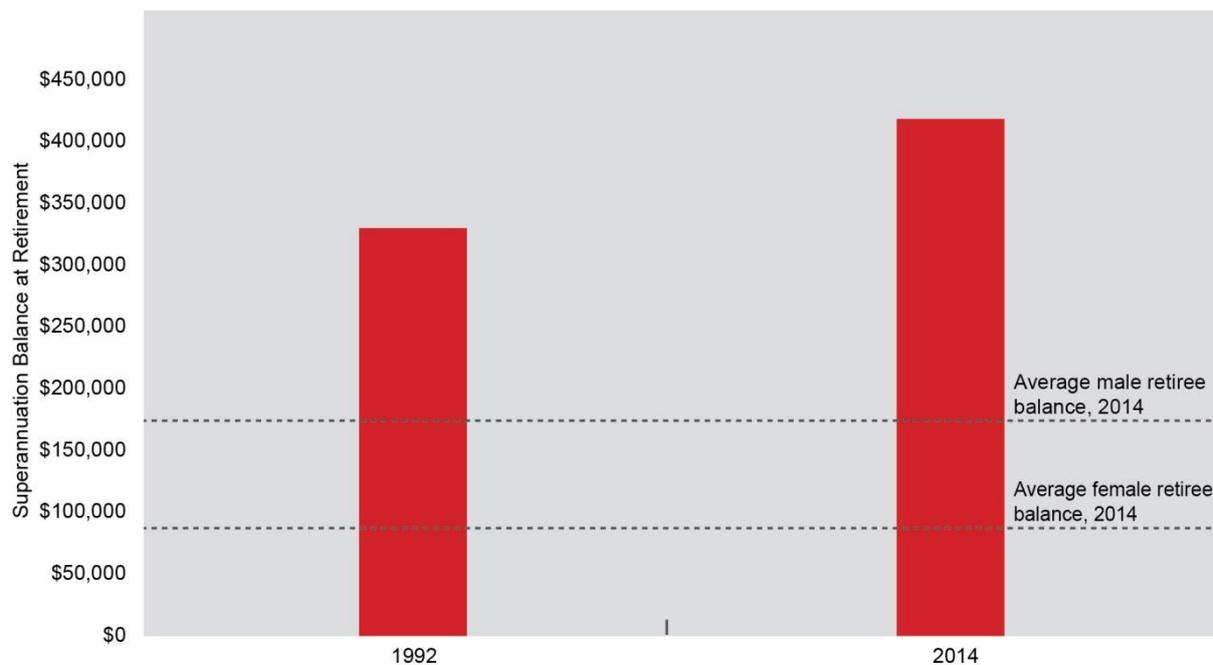
The average retiree superannuation balance today is \$173,000 for men and \$90,000 for women.¹⁰¹ Superannuation balances at these levels are clearly insufficient to achieve the pre-stated member and fiscal objectives. As a result, many people will inevitably need to fall back on the Age Pension.

This highlights the relative immaturity of the superannuation system, having only very recently reached material levels of compulsory contributions (i.e. 9% in 2002) and not reaching 12% until 2022.

This is illustrated in modelling commissioned by Westpac from Deloitte Actuaries in Figure 24, which shows the difference in projected superannuation balances at retirement (age 65) for two otherwise identical 18 year old individuals on median income (based on ABS data, assumed to be \$38,000 today):

- one who joins the workforce in 1992, with the superannuation guarantee commencing at 4%,¹⁰² and
- one who joins in 2014, with the superannuation guarantee at 9.5%.

Figure 24. Projected superannuation balances based on workforce join date



¹⁰¹ ASFA Research, March 2014.

¹⁰² The 4% Superannuation Guarantee rate was applicable to large employers.

Projected retirement incomes

Examining these scenarios from a retirement income perspective, Figure 25 shows the level of retirement income an individual on median income will earn depending on the date they entered the workforce.

Figure 25. Indicative level of retirement income by workforce entry date



This analysis also highlights that the superannuation system will deliver a number of positive benefits as it continues to mature:

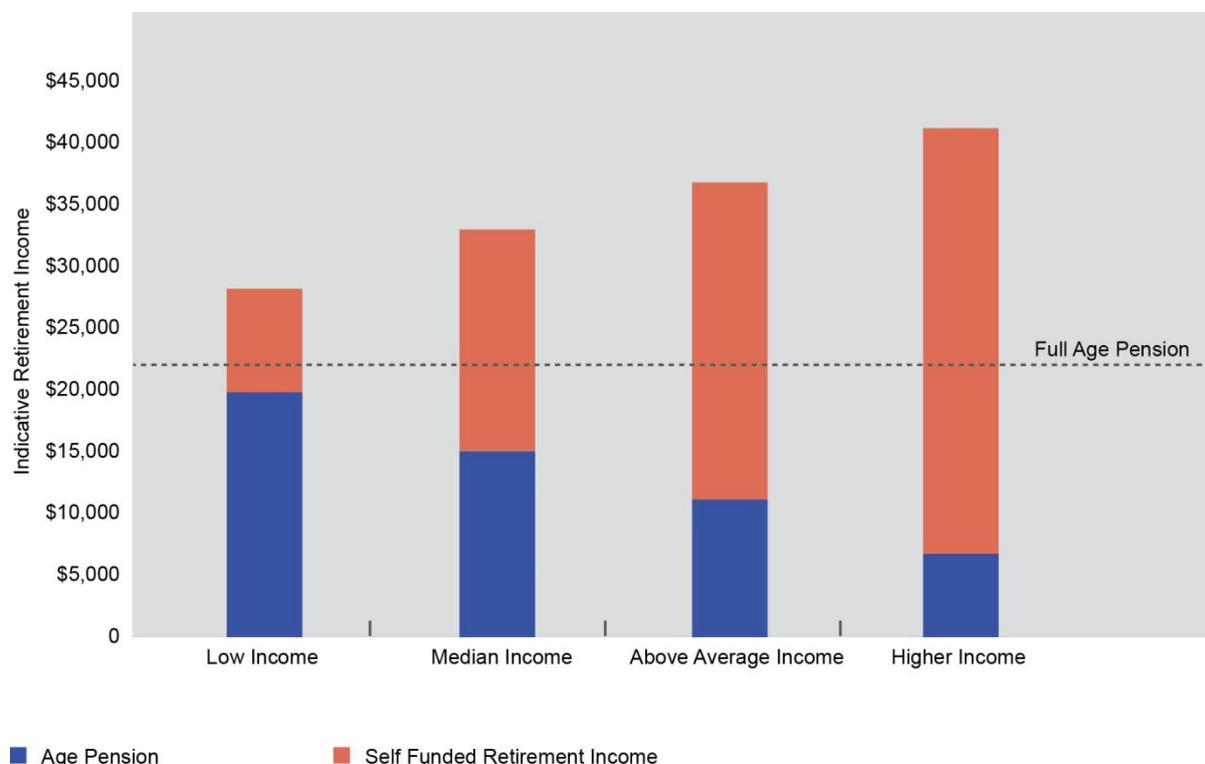
- raising total retirement income levels;
- increasing retirement income replacement rates; and
- reducing the call on the age pension through a greater proportion of private provision.

Thus, there is a greater imperative to ensure the system is properly calibrated for those who will benefit from a mature superannuation system for the duration of their working lives. This group will also have received the full benefits of tax preferred savings - increasing the need to ensure they are not inappropriately reliant on the Age Pension later in life.

The Deloitte modelling found that an individual who commences work at age 18 today and retires at age 65, will have received approximately 70% more superannuation tax concessions throughout their lifetime (including post retirement), when compared to an equivalent person who entered the workforce in 1992.

Just as importantly, the Deloitte analysis highlights that, based on current age pension and superannuation policy settings, there is a significant reduction in age pension provision as incomes rise.¹⁰³ This is illustrated in Figure 26.

Figure 26. Indicative retirement outcomes by income split



In addition to the above, it is also necessary to appreciate the additional challenge posed by increasing longevity. ABS data shows that 25% of all retirees aged 65 and over are currently living into their nineties and beyond.¹⁰⁴

At the same time, increased longevity risk will result in higher health care costs – both for governments and individuals. Retirement income policy settings will therefore need to respond to these needs, by ensuring that individuals are able to afford appropriate levels of health insurance cover during retirement.

This increasing longevity risk combined with the eventuality of adverse health events later in life means it will be inefficient, and in some cases impossible, for all Australians to save for the worst case financial scenario.

Some level of pooling or insurance will therefore be needed to support those who live past mean residual life expectancy from age 65, and who may not otherwise have the means to support themselves for an extended retirement. This residual life expectancy is currently 84 for men and 87 for women, and likely to be significantly longer for subsequent retirees.

¹⁰³ Low Income individuals are assumed to be earning half Median Income (assumed \$38,000 for an 18 year old today). Above Average Income are assumed to be earning 50 % more than Median. Higher Income are assumed to be earning double Median Income.

¹⁰⁴ Australian Bureau of Statistics, Deaths, Australia, 2012.

8.1.3 Current retirement market

The vast majority of retirees who purchase a private pension in Australia do so through an Account Based Pension.¹⁰⁵ These products provide individuals with a high degree of flexibility on how they structure their investments and how much income they elect to draw down. Essentially, Account Based Pensions are a tax and legal structure within which retiree investors can hold a broad range of assets and construct portfolios that reflect their needs.

When portfolios are constructed in a robust way, this product structure provides a high probability of meeting retirement income needs - albeit without any pooled or longevity insurance component.

As highlighted in Westpac's Initial Submission and observed by the Interim Report, Australians are largely doing the right thing in retirement. While there is evidence to support disengagement during accumulation, the same evidence is not available for those approaching retirement. Research has consistently found that there is a very strong correlation between levels of engagement and either age or account balance.¹⁰⁶

Evidence shows that, for the most part, members want to make their savings last as long as possible. This is borne out in the increasing take up of retirement income streams and the majority of members only drawing down the minimum level of income required.

8.1.4 Mandating the use of income streams would not be in members' best interests

Westpac does not support the suggestion that the purchase of a specific income stream (of any type) at retirement should be made compulsory. Removing member discretion at retirement could undermine confidence in the system. Many individuals would be likely to save less voluntarily to avoid the Government dictating how they are able to use their savings in retirement.

Additionally, individual retirement income decisions should be made in a holistic fashion, taking into account the entirety of an individual's personal circumstances. These factors include an individual's aspirations, health, home ownership, debts and other financial assets and that of any partner or spouse.

Mandating that all retirees convert their accumulated balance into a lifetime annuity would be particularly inappropriate for those with small balances. Based on currently available rates, a member with \$100,000 would only be able to improve their post retirement income by \$4,000 per annum if they converted their whole balance into a lifetime annuity.¹⁰⁷

Compulsion may also introduce a significant timing risk at the point at which a compulsory income stream is required to be taken out – on the assumption that the income stream is guaranteed. This may result in retirees facing significantly different outcomes, solely on the basis of prevailing interest rates at the time of retirement.

¹⁰⁵ Plan for Life 2014, data provided to Financial System Inquiry, 23 June 2014

¹⁰⁶ FSC/ING Superannuation - Australia's View, 2013

¹⁰⁷ BTFG calculation.

In effect, this is a type of sequencing risk that must be carefully considered. Falling interest rates since the GFC have been directly correlated with lower returns offered via annuities. If retirees were forced to purchase a lifetime annuity at these historic low interest rate levels, they would be forced to lock in an otherwise lower level of income for the remainder of their lives.

This has been observed in the UK, which has a much larger annuities market than Australia. The Financial Services Consumer Panel in the UK found that annuity rates had fallen steadily over the past 20 years, due to increasing longevity and falling gilt yields among other factors. In 2009, an annual annuity of £5,000 would have required a lump sum of £118,000 for a man aged 65 or £133,500 for a woman. In 2013, the same income would require a lump sum of £152,800 (for a man or woman).¹⁰⁸

Finally, compulsion would likely introduce a level of systemic risk that does not exist today – particularly if a single guaranteed annuity- type product was mandated.

As outlined above, Australia has a predominantly account based pension retirement market. Account based pensions are not prudentially regulated and therefore do not provide a promise of guaranteed income. Conversely, lifetime annuities are offered by life insurance companies which are prudentially regulated because of the lifetime promise they are making to policyholders.

As a consequence, the failure of a life insurer would present a major systemic risk to the system. Compulsion into a specific product type would also risk introducing an implied Government guarantee should there be product failure – be it singular or widespread.

Retirees would likely argue that the Government did not offer them a choice and required them to invest their life savings into a particular product, irrespective of their personal circumstances. This approach would also not reflect the reality that individuals may legitimately require access to funds outside of regular income payments.

8.1.5 Defaults as a mechanism to drive behaviour

The concept of a default option in retirement is likely to be preferable to compulsion on policy grounds.

However, subject to how any default system is designed, many of the shortcomings of compulsion would still potentially be applicable. Were a lifetime annuity determined to be the default, for example, the sequencing risk identified above would be equally relevant. Additionally, it would impede competition on an ongoing basis given the capital costs of withdrawing from the annuity, if this is even possible.

A principles-based default system would therefore address the adverse behavioural response likely to be associated with compulsion (i.e. opting out of voluntary contributions), and could provide greater flexibility and the ability to develop a better solution.

¹⁰⁸ Financial Services Consumer Panel, Annuities and the annuitisation process: the consumer perspective, 2013

This approach would require the regulatory parameters to be principles-based rather than contain product prescription. The principles should outline the outcome which is sought, with only products that can achieve the desired outcomes being eligible and/or attracting incentives.

The onus should be on the trustee to determine what constitutes an appropriate default for their members within these parameters. Any default system would need to be supported by an integrated advice model which provided targeted, simple advice to members to ensure that the default was properly calibrated. This is consistent with the views expressed by the Cooper Review.

In considering any default, the UK provides a useful case study. A Thematic Review of Annuities conducted by the Financial Conduct Authority (FCA) in February 2014 concluded that some parts of the annuity market were not working well for consumers. In particular, the review found that the majority of consumers (60%) do not switch providers when they buy an annuity, despite the fact that the FCA estimates 80% of these consumers could get a better deal on the open market.¹⁰⁹

This highlights the challenge of a default model which may entrench disengagement and, in doing so, reduce competition and result in lower retirement incomes for members.

8.1.6 Incentivising the take-up of appropriate retirement income streams

Providing policy incentives for the take-up of appropriate retirement income streams has a range of benefits compared with the introduction of a default system and compulsion.

It would enable individuals to select the most appropriate retirement income streams from a range of products that could meet their needs. This approach would be more likely to ensure that the most economically efficient solution was available for any given retiree. Such a framework would result in a wider range of products being available for retirees. The introduction of appropriate incentives would allow a market for pooling and insurance type products to emerge.

Importantly, while some retirees might prefer a lifetime annuity, others may decide a deferred lifetime annuity is more appropriate; still others might only need some form of capital protection which may only be triggered where their portfolio suffers a significant loss in value. To be effective, policy incentives would need to be sufficient to drive the desired behaviour.

The design of appropriate policy incentives required to encourage this behaviour will likely mean that existing tax, superannuation and welfare concessions need to be reviewed. A system based on incentives will only be effective if it is properly integrated with eligibility arrangements for the age pension. The design of appropriate policy incentives should be left to the Tax White Paper process to determine in light of its wider remit.

8.1.7 Combination of default model and policy incentives

Westpac supports the combination of a carefully designed trustee determined default model, together with the introduction of appropriate policy incentives.

¹⁰⁹ Financial Conduct Authority, Thematic Review of Annuities, February 2014

The system should be supported by an integrated advice model which provides targeted, simple advice to members to ensure that the trustee's default product is both appropriate and properly calibrated to their circumstances.

Proposed Framework

Westpac proposes consideration of a framework which addresses the overarching member and fiscal policy objectives of the system,¹¹⁰ as well as the various shortcomings identified above relating to compulsion and certain default options.

This framework assumes that the core elements of the system would remain into the future:

- significant but not uncapped tax concessions;
- 9.5% to 12% superannuation guarantee; and
- the capacity to make appropriate levels of voluntary contributions.

The framework centres on the need for as many Australians as possible to underwrite a minimum level of income (up to a maximum of the value of the Age Pension) for the duration of their retirement. This achieves the fiscal objective of superannuation.

Westpac believes that it is fundamental that individuals receive a retirement income which is at least equal to the full age pension. Hence, as retirement savings increase and eligibility for the full age pension decreases, Westpac proposes that individuals are strongly incentivised to convert at least a portion of their accumulated retirement savings into an appropriate income stream. This income stream would underwrite an amount up to the value of the full age pension.

If this model were in place, Deloitte modelling shows that (under current superannuation and age pension policy settings, as well as market rates of annuity purchase) only individuals who accumulate balances greater than \$1.1 million (in today's dollars) would be incentivised to fully underwrite the value of the age pension.¹¹¹ As the focus should be on the value of income received, the lump sum required to produce such income will vary over time, and should not be defined explicitly.

To the extent that an individual is able to save more than the amount sufficient to generate this income (equivalent to the full age pension in this case), the individual would be afforded flexibility in relation to how this excess is utilised. This would include the flexibility of taking some or all of their balance as a lump sum.

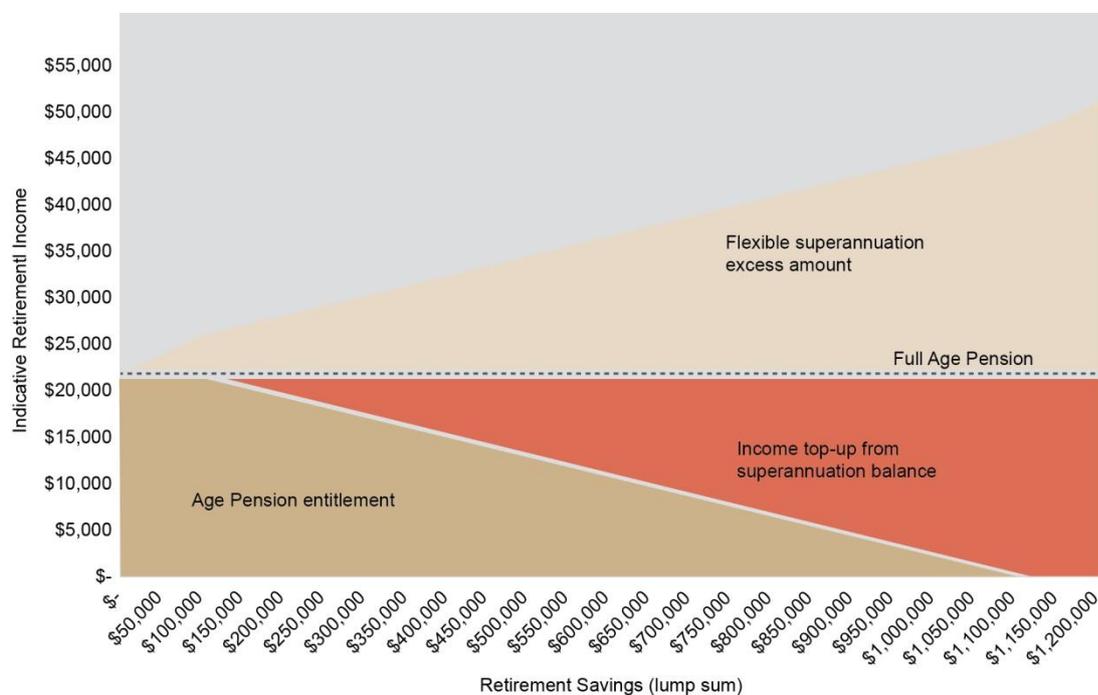
Should the situation occur where this excess amount is diminished or lost, this individual will still have generated an annual income equivalent to at least an age pension, without further recourse to the government/taxpayer.

¹¹⁰ From a member perspective: the system should aim to deliver a level of income replacement in retirement of up to 65% to 70% for all Australians. From a fiscal policy perspective: the system should be designed to substantially offset the cost of the age pension by making sure Australians can self-fund their retirement (for complete duration of their lives) to the maximum extent possible.

¹¹¹ A 1.1 million balance would be expected to generate more than \$48,000 per annum – the cut off level for the age pension.

Figure 27 illustrates the outcomes for individuals with different levels of retirement savings under current superannuation and age pension policy settings, assuming that the entire excess amount is converted to income.

Figure 27. Indicative retirement incomes under current superannuation and age pension policy settings



The modelling shows that a median income earner would be expected to achieve a retirement savings balance (popularly a “lump sum”) in excess of \$400,000 in today’s dollars, and would be entitled to almost \$15,000 in Age Pension annually under current policy settings.

Under the proposed Westpac model, policy incentives would strongly encourage this individual to convert a portion of their lump sum into a \$7,000 income stream. This would provide them with a full age pension equivalent income.

However, those with small balances (up to approximately \$150,000) would still be able to remain in the 'default' or select from other products, but would not be penalised for failing to take out an appropriate income stream. There is no public policy rationale for these individuals to be required to take an income stream given their full reliance on the Age Pension and limited other means.

Under the proposed Westpac framework, the levels of retirement income needing to be personally underwritten would vary depending on age pension policy settings. Hence, the Government could alter the proportion of private provision by simply altering the age pension taper rate. Westpac recommends that any consideration of these settings be considered by the Tax White Paper process.

For individuals who are subject to the new framework, appropriate policy incentives would encourage them to take out an income stream that satisfied a series of principles-based requirements in order to achieve the desired policy objective. These principles could include:

- providing regular income payments;
- sufficient flexibility to increase or decrease payments, as appropriate, to provide a minimum annual income up to the equivalent to the Age Pension; and
- providing adequate protection against market, inflation and longevity risk, to a value not less than the Age Pension.

These policy incentives would need to take account of an individual's assets outside of superannuation in order to prevent any substitution effect (such as choosing to save less inside superannuation) in order to avoid these rules. Eligibility for the age pension would also need to continue to reflect income and assets inside and outside superannuation.

Under the Westpac framework, individuals would not be discouraged or penalised for choosing to take their benefit as a lump sum provided they had taken out a compliant income stream that, at a maximum, replaces the value of the Age Pension for the duration of their lives – thus offsetting any increase in age pension costs for Government/future taxpayers.

Importantly, because of the principles-based nature of the framework, no single product would be prescribed. Instead, innovation would be encouraged around how best to deliver an income stream that achieves the stated objectives. Individuals could then choose from a range of products and providers which meet the above requirements.

As a result, an individual with a large balance would be able to avoid purchasing separate longevity insurance provided their income stream was structured to replace the value of the Age Pension for the duration of their lives – up to a given percentile to be specified in the principles-based framework (e.g. the 5th percentile of cohort life expectancy).

Compared with the present system, this framework will help to ensure that the fiscal objective of superannuation is met. It will be possible to clearly track age pension savings and therefore the success or otherwise of the system – enabling a more informed policy discussion about superannuation tax and contribution settings.

Critically, this policy framework would not prevent or discourage individuals from saving more to achieve an appropriate pre-retirement income replacement rate that aligns to the member objective for the system (65-70%).

The framework also continues to provide appropriate levels of flexibility in accordance with a defined contribution pension system. Finally, this framework creates a competitive environment within which providers can innovate to develop a range of solutions to suit different retiree circumstances.

Chapter 9 – Technology

Westpac Key Issues and Insights

- Westpac supports the Inquiry’s proposals to amend regulation with the aim of becoming technology neutral and to avoid uneven regulation of industry players, thus avoiding the system discriminating against the use of technological innovation or allowing participants to engage in regulatory arbitrage.
- Development of national strategies in the areas of cyber-security and digital identities are also important initiatives to address the risks of new technology.
- Ultimately, the precise nature of all the impacts of technology on the financial sector cannot be known at this time. For this reason, Westpac reiterates the recommendation in its Initial Submission (also reflected in the Interim Report) that a whole of Government technology strategy should be established, in close consultation with regulators and the industry.

Chapter 9 – Technology

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

Westpac's Initial Submission outlined both opportunities and risks associated with the application of technology to financial services. Among the most important is the emergence of business models through regulatory arbitrage, and the need to ensure customers are protected, and systemic risk is managed. In Westpac's view, these issues are best managed through a comprehensive strategy to ensure the financial system's regulatory framework supports technological innovation, while managing potential risks.

Westpac's specific responses to the Interim Report's policy options are detailed in this chapter.

9.1 Regulation in a digital environment (4-44)

- No change to current arrangements.
- Amend regulation that specifies using certain technologies with the aim of becoming technology neutral. Amendments should enable electronic service delivery to become the default; however, they should include opt-out provisions to manage access needs for segments of the community.
- Adopt a principle of technology neutrality, for future regulation recognising the need for technology-specific regulation on an exceptions basis. Where technology-specific regulation is required, seek to be technology neutral within that class of technologies.

Westpac supports the amendment of regulation with the aim of becoming technology neutral, and the adoption of a principle of technology neutrality for future regulation. Opportunities for regulation to enable innovation in financial services are discussed in detail in Chapter 7 of Westpac's Initial Submission.

9.2 Facilitating innovation (4-51)

- Establish a central mechanism or body for monitoring and advising Government on technology and innovation. Consider, for example, a public-private sector collaborative body or changing the mandate of an existing body to include technology and innovation.
- Establish a whole-of-Government technology strategy to enable innovation.

Westpac supports the development of a comprehensive strategy to ensure the financial system's regulatory framework supports technological innovation, while managing potential risks. This strategy should be developed by Government in close consultation with the financial sector. Further information on this approach is discussed in Chapter 7 of Westpac's Initial Submission.

A key part of the technology strategy should be to ensure regulatory obligations are imposed on a functional, rather than business-model basis - 'same service, same regulation'. Poor or uneven regulation can allow some participants to build businesses through 'regulatory arbitrage,' where a lack of regulation and oversight provides the basis for business models. This can pose significant systemic risks for the financial system.

Westpac believes there needs to be a clear and articulated public benefit in establishing a central mechanism or body for monitoring and advising Government on technology and innovation. Market-based innovation, overseen by our existing financial system regulators, is preferable and would provide a more efficient outcome. The establishment of a central mechanism or body raises the risk that innovation could be unintentionally hindered through the creation of another regulatory and oversight layer.

9.3 Managing information (4-55)

- Review and assess the new privacy requirements two years after implementation to consider whether the impacts appropriately balance financial system efficiency and privacy protections.
- Review record-keeping and privacy requirements that impact on cross-border information flows and explore options for improving cross-border mutual regulatory recognition in these areas.

Westpac supports reviewing both new privacy requirements and record-keeping, and privacy requirements that impact cross-border information flows.

The current inconsistency of privacy obligations in the financial sector should form part of this review. For example, marketing letters are regulated by the Privacy Act, marketing emails by the Spam Act, and marketing phone calls by the Do Not Call Register Act. Furthermore, banks are subject to a common law duty of confidentiality to customers that do not apply to other financial providers, such as superannuation funds. The inconsistent privacy treatment of customer information in the financial sector makes it difficult to balance system efficiency and privacy protections.

Naturally, there is considerable complexity in dealing with privacy obligations in cross-border information flows, which mean that organisations need to effectively choose between laws (e.g. the challenges in dealing with obligations between Australia and a multitude of Pacific banking jurisdictions).

Australian laws also have territorial aspects, which adds further complexity, and also supports the benefit of the reviews noted by the Inquiry.

9.4 Data security and cloud technology (4-58)

- Implement mandatory data breach notifications to affected individuals and the Australian Government agency with relevant responsibility under privacy laws.
- Communicate to APRA continuing industry support for a principles-based approach to setting cloud computing requirements and the need to consider the benefits of the technology as well as the risks.

Westpac fully supports principles-based regulation for Cloud computing and many other areas of the application of technology in financial services. A principles-based approach can successfully manage the rapidly changing business and technology environment within which financial sector providers operate.

9.5 Cyber security (4-63)

Review and update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation and progress public–private sector collaboration.

- Would a private–public sector discussion forum for strategic issues, such as cyber crisis planning, improve cohesion in implementing cyber security policy? What other mechanisms might assist to improve cohesion or coordination?
- Is there a need for more cross-sectoral or transnational mechanisms for information sharing, or for Government to work with industry to initiate the development of a collaborative model similar to the United States FS-ISAC?
- How useful would a voluntary cyber security framework, similar to that of the United States NIST, be in assisting industry to develop cyber capabilities?

Westpac supports the review and update of the 2009 Cyber Security strategy, and the Inquiry’s interest in improved cohesion and coordination in this space. The Australian Cyber Security Centre (ACSC) should remain a focal point for Government and industry collaboration for the successful management of cyber security risk. The ACSC provides the ideal forum for the industry to collaborate with the intelligence community and would enhance practical information sharing.

Further, Westpac believes there would be considerable value in implementing a more collaborative model to deal with cyber-crime, similar in nature to the USA FS-ISAC model. This model provides an operational capability (i.e. staff on the ground) to ensure that information is collected, understood and distributed as close to real-time as possible, allowing member organisations to respond to emerging threats quickly. Deep operational connections between such a collaborative mechanism and the ACSC would be valuable.

9.6 Digital identities (4-70)

Develop a national strategy for promoting trusted digital identities, in consultation with financial institutions and other stakeholders.

- In developing a national strategy, what should be the respective roles, responsibilities and expectations of Australian public and private sector organisations in creating, accepting and maintaining the digital identities used by Australians?
- Is there a need for Government to enhance identity authentication by facilitating interoperability standards in areas such as biometrics, enabling better access to Government information or improvements to the Documentation Verification Service?

9.6.1 National strategy for promoting trusted digital identities

Westpac supports the establishment of a national strategy for promoting trusted digital identities. This strategy should focus on increasing efficiency.

At present, most identity documentation is physical and must be presented in branch. Alternatively, relying on a third party's identity information digitally involves either a web of bilateral agreements or relying on a bureau. If the agreements and protocols by which identity information is verified can be standardised, digital identity establishment should become less expensive and more secure.

Improving opportunities for the digital verification of customers (including through expansion of the Document Verification Service) would both reduce systemic inefficiencies and improve security and fraud outcomes across the financial sector.

9.6.2 Interoperable authentication credentials

The notion of interoperable authentication credentials has been a complex issue globally, and in Westpac's view, there would be limited utility in Government investing significant time and resources in this area. If this objective were to be pursued, Westpac believes it should be built for purpose rather than grafted into the existing myGov service. The existing myGov service has experienced a number of public vulnerabilities, which suggests that it was not built for-purpose as a high-security system.¹¹²

Similarly, trusted digital identity, referred to at page 4-64 of the Interim Report, should not in Westpac's view be a priority in the development of a national digital identities strategy. A number of attempts have been made in this direction – the National Trusted Identities Framework, Gatekeeper, Trust Centre – all have fallen short of their goals, or been unsuccessful. The technology is easy, but the business models are hard, particularly the revenue model, the liability framework, and the interaction between the two.

In the absence of a clearly articulated need for shared credentials, this is a significant program to attempt without a clear benefit. Instead, focus should be placed on:

- establishing a user's identity in a new relationship based on their other relationships; and/or
- authenticating a single user to a number of providers.

9.6.3 Biometrics

Westpac agrees with the analysis at page 4-69 of the Interim Report regarding the challenges of biometrics. These technologies are still subject to high error rates, low consumer acceptance, and questions around credential compromise and reset (i.e. it is not possible to 'password reset' on a retina scan once the data is compromised).

Westpac will continue to monitor the effectiveness of emerging biometric technologies and take a 'test and learn' approach to their implementation. However, Westpac suggests that material recommendations proposing industry-wide investment in, or standardisation of, biometrics are not appropriate at this point.

¹¹² <https://www.nikcub.com/posts/multiple-vulnerabilities-in-mygov-australian-government/>, <http://www.smh.com.au/it-pro/government-it/australians-private-government-details-at-mercy-of-hackers-say-it-security-experts-20140428-zqzkg.html>

Conclusion

Australia's financial system is highly integrated and inter-connected. While the policy options raised in the Interim Report demonstrate the array of individual parts of the financial system, they are all ultimately linked.

For this reason, it is vital that the Inquiry considers these policy options not only as discrete measures, but as elements of a single blue-print for the financial system. This necessarily involves priorities, trade-offs and, most importantly, it involves balance. The way the financial system balances objectives such as efficiency, stability and flexibility is the ultimate measure of its effectiveness.

Westpac believes that, presently, Australia's financial system resolves this question of balance well. The system has supported the nation through a sustained, and continuing, period of economic growth and prosperity, absent the dislocation and crises seen overseas. Banks have focused heavily on improved capital and liquidity holdings, and increasing the resilience of their funding bases. Australia now has a significantly stronger banking sector than it did before the GFC.

The system's support of the nation has been achieved through a market-based approach, an appropriate statutory and regulatory framework, and through well-managed, sound institutions. All of the system's components play their part.

That said, there are always opportunities for improvements to the financial system, and Westpac's Second Submission has canvassed many of these ideas. Opportunities for improvement are especially important given the significant change that continues to impact the system – through technology, the growth of superannuation, demographics and greater international integration.

Through all of this change, maintaining appropriate balance between the system's objectives should continue to be a fundamental goal for Government, regulators and, Westpac believes, the Inquiry. Measures that weigh heavily in one direction – be that stability, efficiency or any other objective – tend to affect the system in unpredictable ways. They can have unintended consequences for institutions and, most importantly, for customers.

Confidence in the operation of the financial system, certainty in its regulatory framework, and trust in its institutions, should continue to be aspirations for the system's stakeholders. Westpac will continue to assist the Inquiry in achieving these goals.