Submission to the *Financial System Inquiry Final Report*

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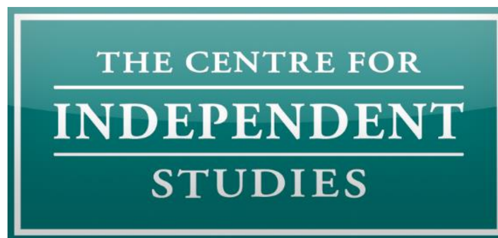

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OVERVIEW

Responding to the **Treasury's invitation for submission** on the final report of the Financial System Inquiry (FSI), the scope of this submission is to comment on the broad issues raised by the Inquiry and on some particular recommendations demanding further attention. In particular, this document will focus on Chapters 1 (Resilience) and 4 (Consumer Outcomes) of the FSI report.

Overall, the FSI report is a well-balanced, liberal document based on a cost-effective, minimal government intervention approach, recognising the irreplaceable contribution of free market forces and the role of competition, where *'the private sector is best placed to make decisions affecting the efficient allocation of resources'*.[1]

Nonetheless, some specific recommendations are of concern, as they seem to go against the tenets of the Inquiry's philosophy of promoting efficiency, resilience and fairness in Australia's financial system. In this regard, such recommendations require significant revisions before implementation, if not complete removal.

For instance, **FSI Chapter 1** addresses the resilience of the financial system to reduce the costs and probability of failure, while limiting risk to taxpayer funds. Generally speaking, adjustments to the current financial framework have to be made, but hastening untested theories without a proper cost-benefit analysis risks compromising the vitality and endurance of Australia's financial institutions. More specifically, the lack of a firm consensus on what constitutes 'unquestionably strong' capital levels seems to lead to an unwarranted trade-off between an unquestionable rise in financial costs without the guarantee of higher resilience. **Section I** of this report will address the matter in detail.

The recommendations in **FSI Chapter 4** also need further attention. This chapter focuses on consumer outcomes by attempting to enhance confidence and trust in the financial system. There is strong evidence that some of the proposed measures in this chapter risk violating inalienable individual rights. In particular, Recommendation 22 supporting ASIC with a regulatory power that *"would enable intervention without a demonstrated or suspected breach of the law"*[2] is an affront to the Rule of Law principle. Moreover, proposals to introduce mandatory targeted and principles-based product design and distributional obligation[3] and tertiary degree requirements for financial advisers[4] impose unnecessary costs on industry the without a guaranteed benefit to consumers. These issues will be explored in **Section II** of this report.

The remaining chapters of the FSI's final report address other important matters with mostly reasonable recommendations, and therefore will not be addressed in this submission.

[1] Commonwealth of Australia (2014), Financial System Inquiry – Final Report, p. 9.
[2] *Ibid.* p. 206.
[3] *Ibid.* p. 198.
[4] *Ibid.* p. 222.

I. ON THE RESILIENCE OF THE FINANCIAL SYSTEM

As the Inquiry correctly notes, it is vital to strengthen the financial system by making it more resilient, especially under extreme adverse scenarios. Additionally, given the challenges experienced overseas—and at some extent, likewise here in Australia—during the Global Financial Crisis (GFC), something must be done to protect the health of Australia's financial market. Moreover, taxpayers should not be expected to have unlimited liability for excesses committed by a few market players.

Nonetheless, for the reasons laid out below, the recommendations in the **FSI Chapter 1** do not appropriately address the issue of resilience. As a matter of fact, in some cases, should these recommendations be fully implemented as described, they might even exacerbate the systemic risks in Australia's financial market.

It should be noted that the underlying causes for the GFC are still under debate, with no silver bullet devised yet to effectively prevent or even lessen the effects of another international crisis.

After carefully surveying the literature, Lo (2012) clearly refutes any form of consensus on the causes or remedies to the GFC.[5] In short, no single narrative emerges from the collection of writings on the topic. Hence, caution is needed when devising cost-increasing policies in response. That something must be done does not imply that any strategy will do.

Recommendation 1, for instance, advises raising bank capital levels. Put simply, there is no consensus on the optimal level of capital ratios. In fact, as noted by the Inquiry, academic studies provide a varied range of optimal levels, as wide as from 10% to 20% of risk-weighted assets.[6] The Inquiry even recognises that a study on the right amount of capital ratio has never been undertaken for Australia.[7] Indeed, some academic voices even back the 1933 Chicago Plan that would require 100% of deposits to be readily available for withdrawal, completely changing the banking system as we know it.[8]

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[5] Lo, Andrew W. (2012) Reading about the Financial Crisis: A Twenty-One-Book Review, *Journal of Economic Literature*, 50(1): 151-78.

[6] *Op. cit.* p. 58, footnote 43; Galati, Gabriele, and Richhild Moessner (2013) Macroprudential policy–a literature review, *Journal of Economic Surveys* 27(5): 846-878; Miles, David, Jing Yang, and Gilberto Marcheggiano (2013) Optimal Bank Capital, *The Economic Journal* 123(567): 1-37.; Allen, B., Chan, K. K., Milne, A., & Thomas, S. (2012) Basel III: Is the cure worse than the disease? *International Review of Financial Analysis*, 25:159-166; Borio, Claudio (2011) Implementing a macroprudential framework: Blending boldness and realism, Capitalism and Society 6(1); CATO Institute (2011) Capital Inadequacies – The dismal failure of the Basel regime of bank capital regulation, *Policy Analysis*, July; Roger, S., & Vlček, J. (2011) Macroeconomic costs of higher bank capital and liquidity requirements. IMF Working Papers No. 11/103; Hanson, S. G., Kashyap, A. K., & Stein, J. C. (2010) A macroprudential approach to financial regulation, Chicago Booth Research Paper 10-29; Barrell, R., Davis, E. P., Fic, T., Holland, D., Kirby, S., & Liadze, I. (2009) Optimal regulation of bank capital and liquidity: how to calibrate new international standards FSA Occasional Paper no. 38, October.

[7] *Op. cit.* p. 58.

[8] Cochrane, J. H. (2014) Toward a run-free financial system Chicago Booth School of Business; Benes, J., & Kumhof, M. (2012) The Chicago plan revisited Washington, DC: International Monetary Fund WP12/202; Chen, Q., Goldstein, I., & Jiang, W. (2010) Payoff complementarities and financial fragility: Evidence from mutual fund outflows *Journal of Financial Economics*, 97(2): 239-262; Phillips, R. J. (1992) The Chicago Plan and New Deal Banking Reform Jerome Levy Economics Institute Working Paper, (76).

Moreover, the Inquiry advocates for *"a baseline target in the top quartile of internationally active banks"*.[9] However, there is no theoretical nor evidence base in the FSI report for why the top quartile was picked, which makes it an arbitrary number. Capital requirements should not be treated like an Olympic medal tally.

Hastening new capital level requirements is not advisable. Firstly, there is no consensus on how to assess capital requirements — indeed this is the reason the Inquiry is correctly pushing in **Recommendation 4** for transparent reporting in order to alleviate the problem. In the words of the inquiry: *"…it is highly complex to compare even two jurisdictions, let alone to compare all jurisdictions";*[10] *"no benchmark of international practice exists for calculating capital ratios";*[11] and *"simply comparing Australian bank capital ratios to those reported by their international peers may therefore be misleading".*[12] Without a broadly accepted yardstick, how should Australia's position in the implied 'global race' for capital requirements be determined?

Secondly, contrary to what the FSI states, the expected cost of increasing capital requirements is not small — especially for the authorised deposit-taking institutions (ADIs) involved.[13] Capital requirements costs are dynamic, non-linear and at many points stochastic, which means that they are extremely hard to predict and vary in nature and volume according daily conditions of the market.[14] Were these costs small as claimed in the report, it would be in the best interest of the banking industry to voluntarily acquire higher capital levels. The fact that benefits from capital requirements have diminishing marginal returns and carrying costs are convex is precisely what creates the opportunity for an optimal level of capital. The problem is that, as mentioned above, the optimal point is currently unknown.

Lastly, the debate on the desirable capital standards for ADIs needs to be put in perspective. The Australian financial system (in particular Australia's ADIs) performed extremely well during the GFC, which was considered by many to be the largest financial crisis since the '1929 Crash'. Australia's financial system must be strengthened and prepared in case—or when—a new GFC arises. Yet that does not justify the hasty implementation of untested theories with unpredictable potential benefits and likely high costs to the industry. Ultimately, a healthy and resilient financial system relies on healthy and resilient industry members, and imposing unnecessary costs does not help achieve this outcome.

Following the same rationale, the implementation of **Recommendation 2** on narrowing mortgage risk differences should be handled with care. The proposed range between 25–30% is again an arbitrary number with no sound evidence base supporting it in the report. The internal-based models to assess risk constitute a desirable goal supported by APRA, which requires a *'sophisticated risk management framework and capacity'*.[15] If the ultimate goal of Recommendation 2 is indeed to narrow mortgage risk differences, and therefore promote more competition in the banking industry, the government could promote instead two other alternative (albeit non-exclusive) options:

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[9] *Op. cit.*, p. 41.
[10] *Ibid.* p. 50.
[11] *Ibid.* p. 76.
[12] *Ibid.* p. 76.
[13] Australian Bankers Association Inc. (2014) Financial System Inquiry – Response to Interim Report, Second Round Submission.
[14] Galati, Gabriele, and Richhild Moessner (2013) Macroprudential policy–a literature review, *Journal of Economic Surveys,* 27(5): 846-878.
[15] *Op. cit.* p. 60.

1) APRA could work with non-IRB smaller banks in obtaining the accreditation under a simpler and less costly process;

2) The difference in mortgage risk weights could be obtained not by forcing IRB banks to increase their average from 18% to a minimum of 25%, but instead fostering the non-IRB bank average to lower from the current 39% to the minimum Basel framework compliance of 35%.

Recommendation 3 on loss absorbing and recapitalisation capacity regards the important topic of financial stability. Yet it does not tackle the issue in the right way. In the words of the Inquiry, *'this area is complex and evolving'*;[16] *'…the Financial Stability Board (FSB) is* [still] *consulting on an international framework for loss absorbing and recapitalisation capacity…'*[17] Indeed, the topic is currently debated in academia, with no sound consensus.[18] Although there is a window for improvement on this front, any decision should be based on a broad international consensus once available, and carefully take into account the implementation costs.

The same cautious approach is indicated for **Recommendation 7** on leverage ratios, which clearly imposes strong restrictions in the banking industry with no clear consensus on respective optimal levels. That is, a backstop leverage ratio should only be implemented after an extensively justified case is made based on international success stories and accompanied by a rigorous cost-benefit analysis.

On **Recommendation 5** regarding a crisis management toolkit, it advises strengthening crisis management powers in order to secure a clear, orderly and fair resolution of distressed financial institutions. Yet, a deeper consultation process with relevant stakeholders in industry should be in place for a more effective, bottom-up design.

Another point of concern regards **Recommendation 8** on the direct borrowing exception to self-managed super funds (SMSFs). The Inquiry's concern of *'unnecessary build-up of risk in the superannuation system'* understandable, but one should not throw out the baby with the bathwater. Property investment is a perfectly valid form of long-term investment, aligned with the principles guiding superannuation. On the one hand, it is true that the amount of funds using the limited recourse borrowing arrangement (LRBA) presented a steep increase in the last years, but they still constitute less than 0.49% of total SMSF funds.[19] In any case, the risks associated with this investment strategy are extremely low. According to the SMSF Professional Association, the default rate on loans to buy business property is less than a quarter of 1%.[20] In addition, the self-managed super fund industry is keen to work with the government to find viable solutions short of the extreme option of shutting down a prosperous investment opportunity.[21]

Lastly, on a good note, **Recommendation 6** on the financial claims scheme (FCS) is on the right track. The current FCS funding model should be retained in full by the government, including the *ex post* funding option in order to avoid unnecessary costs to the industry. The FCS is a balanced trade-off between moral

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[16] *Ibid.* p. 67.

[17] *Ibid.* p. 69.

[18] International Banking Federation (2015) Adequacy of loss-absorbing capacity of globally systemically important banks in resolution; Maes, S. and Schoutens, W. (2012) Contingent Capital: An In-Depth Discussion, *Economic Notes*, 41: 59–7; CATO Institute (2011) Capital Inadequacies – The dismal failure of the Basel regime of bank capital regulation, *Policy Analysis*, July; Fillat, J. and Montoriol-Garriga, J. (2010) Addressing the pro-cyclicality of capital requirements with a dynamic loan loss provision system, Federal Reserve Bank of Boston Working Papers.

[19] SMSF Professionals' Association of Australia (2014), Financial System Inquiry Submission 2014.

[20] Australian Financial Review (2015), SMSF property crackdown spooks business. Accessed on February 13th, 2015.

[21] Australian Financial Review (2015), DIY super push back on debt ban. Accessed on February 21st, 2015.

hazard incentives and avoidance of systemic bank runs. An *ex ante* funding would ultimately constitute an indirect tax on savers. As the Inquiry says: *"the FCS is a fundamental component in protecting depositors in Australia, providing a guarantee on deposits of up to $250,000 per account holder per ADI. The FCS allows depositors to access protected deposits quickly, without having to wait for a liquidation process to be completed."*[22]

[22] *Op. cit.* p. 82.

II. ON CONSUMER OUTCOMES

A fair treatment towards consumers, and trust in markets, are valuable assets reducing unnecessary transaction costs. Hence, the Inquiry is right to support *"industry and Government efforts to increase financial inclusion"*[23] and to promote the guiding principle that "*consumers should bear responsibility for their financial decisions*".[24] However, some recommendations in *Chapter 4: Consumer Outcomes* are in contradiction to the Inquiry's commitment to cost-effective regulations and reasonable government intervention in the private sphere.

Recommendation 21 to strengthen product issuer and distributor accountability, for instance, intends to *"reduce the number of consumers buying products that do not match their needs"*.[25] Affected industries have already said that this recommendation will inevitably increase product costs, decrease product options, and impose prohibitive additional compliance costs.[26] The guiding principle is that one should be wary of regulations that might unnecessarily increase costs or hinder innovation. Nonetheless, should the government still opt to implement Recommendation 21, the industry should be part of the process. In this regard, an eventual implementation process should fully take into account that transparency and the individual's responsibility and freedom to choose guide an optimal mix of financial products.

Another concern regards the impact of **Recommendation 22** on the introduction of new product intervention powers for ASIC. An effective and powerful regulator is desirable and needed. Yet it goes without saying that such powers should be under the limits of the law. Notwithstanding this, in the fine print of Recommendation 22, there is a claim for the Australian Securities and Investments Commission (ASIC) to have a regulatory power to intervene *"without a demonstrated or suspected breach of the law".*

By any measure, this is a clear breach of the Rule of Law principle. The principle that 'everything not forbidden is allowed' constitutes an essential freedom of the ordinary citizen that is ingrained in Australia's legal system.

The Inquiry claims the last resort power outlined in Recommendation 22 could be used as a pre-emptive measure where there is risk of significant detriment to a class of consumers. Accordingly, ASIC would be able to amend marketing and distribution materials, restrict distribution, and even impose bans on products. In its defence — and with the benefit of hindsight — the report cites cases where, had these powers been in place, much harm would have been avoided.

The proposed uber-regulatory control is fundamentally flawed. It is based in the idea that someone — without judicial consent and against the constitutional right of due legal process — is able to prevent an evildoing on the basis of prophetic ability. Regulators should always address those who have done wrong according to the strict boundaries of the law.

Moreover, Recommendation 22 also overstates the ability of any government to pre-emptively identify any *"significant detriment arising from consumers buying financial products they do not understand"*[27] as

[23] Commonwealth of Australia (2014), "Financial System Inquiry – Final Report", Chapter 4: Consumer Outcomes, p. 193.
[24] *Ibid.* p. 197.
[25] *Ibid.* p. 198.
[26] Australian Bankers Association Inc. (2014) Financial System Inquiry – Response to Interim Report, Second Round Submission.
[27] *Ibid.* p. 207.

well as underplaying the ability and responsibility of the consumers to understand whatever they are buying.

Another heavy-handed intervention measure involves **Recommendation 25** on raising the competency of advisers. More specifically, this recommendation requires a "*relevant tertiary degree"* for those advising on Tier 1 products.[28] The Inquiry even recognises: *"for individual advisers and firms, the cost of undertaking further and ongoing education would be significant"; "raising the minimum competency standards may increase the cost of advice for consumers";* and "*the requirement for higher education standards may cause some existing advisers to exit the industry and may deter some from entering, potentially causing an 'advice gap' for some consumers*".[29]

Increasing education standards among financial advisers is a laudable cause. But restricting the avenues to achieve that goal is not.

If implemented, a mandatory tertiary degree requirement will largely increase the costs of financial advice across the industry as well as usurp consumers' discretion and responsibility for their financial decisions. Worse, the implementation would come with no guaranteed improvement to the quality of services.

A formal three-year bachelor degree costs tens of thousands of dollars to attain. Yet, to date, there is no formal body of theory regarding financial planning that could serve as the basis for tertiary education on the subject.[30] The end result might therefore be an education-related debt burden for financial advisers, pushing up the financial advice fees to consumers accordingly.

A better solution would be for ASIC to work closely with industry to revamp the minimum standard of knowledge financial advisers should master, and let the market create different degrees and certifications.

Transparency and choice are the key drivers towards a competitive environment, where consumers can freely choose—and pay accordingly— for the services. Different accreditations lead to different pricing. And with the new Financial Advisers Register, consumers will have better information to make their own judgements whenever purchasing financial advice. Consumers—not regulators—should have the ultimate say on which financial advice standards they are willing to pay for.

Regarding **Recommendation 24** on aligning the interests of financial firms and consumers,[31] and **Recommendation 26** on improving guidance and disclosure in general insurance,[32] it is understood that a liberal society based on the Rule of Law principle and respect for private property has to address, whenever possible, the problem of information asymmetry in contracts. Indeed, a badly designed system can exacerbate the principal-agent problem. Hence, both recommendations move in the right direction, since both intrinsically aim to improve consumers' understanding of risks and responsibilities on their choice of contracts. Nevertheless, it is vital to uphold the imperative of a more consultative, bottom-up approach with industry and consumer groups as a more effective option than unilateral government actions.

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[28] *Ibid.* p. 222.
[29] *Ibid.* p. 225.
[30] Brimble, M., and Murphy, B. (2012) Past, Present and Future: The Role of the Tertiary Sector in Supporting the Development of the Financial Planning Profession, Journal of Business Ethics and Education, 9 Special Issue: 105-124; Warschauer, T. (2002) The Role of Universities in the Development of the Personal Financial Planning Profession, Financial Services Review, 11(3): 201-216; Black, K., Ciccotello, C. S., and Skipper, H. (2002) Issues in Comprehensive Personal Financial Planning, *Financial Services Review*, 11(1): 1-9.
[31] *Ibid.* p. 217.
[32] *Ibid.* p. 227.

Lastly, **Recommendation 23** on facilitating innovative disclosure appears to be a good move to reduce excessive costs. Indeed, in light of technological developments, a self-regulatory and flexible approach to improve industry's communication with consumers is more effective and less costly than prescriptive regulations that usually imply higher compliance overheads. Hence, Recommendation 23 is welcome when it prescribes the removal of unnecessary *"regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers"*.[33]

[33] *Ibid.* p. 213.

CONCLUDING REMARKS

This submission aims to provide a constructive critique and analysis of the final report of Financial System Inquiry published on December 7, 2014. Overall, the FSI report is a well-balanced, liberal document to improve Australia's financial system, but there are several significant flaws.

The scope of this submission is to comment on the broad issues raised by the Inquiry and on some particular recommendations requiring further consideration and discussion. In particular, it focuses on FSI Chapters 1 (Resilience) and 4 (Consumer Outcomes), in which some of the report's recommendations are counter-productive and work against the Inquiry's original mission to make the Australian financial system more resilient, efficient and fair.

It is in Australia's best interest to adopt a cautious and wise implementation of regulatory changes in order to avoid unnecessary costs to the industry. Ultimately, the strength of the financial system lies in the business strength of its members.

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