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Financial Services Risk and Regulatory Review

Making the right choices

May – July 2013

Contents

Executive summary

In this issue of Risk and Regulatory Review we consider some of the topics that are defining the 2013 financial services industry agenda with a particular focus on the current flurry of domestic and international regulator activity.

We cover one of the major impacts of regulatory reform under Basel III - the introduction of internationally harmonised global liquidity standards as a minimum requirement. Given that the aim of harmonised global liquidity standards is to improve banks' liquidity and reduce the risk of insolvency, we explore how this inaugural introduction of global liquidity standards is likely to impact banks' funding structures across the globe, as well as influence the pricing of deposit products and, potentially, banks' profitability.

We review the final FATCA regulations which were issued in January this year and which contain numerous changes from the draft regulations. Our article summarises the changes and provides an action timeline for the critical 1 January 2014 go live date.

Since our last quarterly Risk and Regulatory Review (December 2012 – March 2013), ASIC has announced further guidance on the upcoming FOFA reforms, recently releasing regulatory guides relating to fee disclosure statements (Regulatory Guide 245) and conflicted remuneration (Regulatory Guide 246). With all planned regulatory guides on FOFA now issued, we summarise the guidance in our ASIC update section page 37. We will take the opportunity to revisit the FOFA regulations and discuss the various impacts, challenges and opportunities we foresee in our next Risk and Regulatory review in July.

As one of the most downloaded items of research from our Deloitte website this month, we also include our Actuarial and Consulting team's analysis of APRA's statistics to comment on the composition and governance, as well as the growth and size of the superannuation market in Australia. In parallel we consider what an internal audit function can do for a superannuation trustee – whether in or out of house, or a hybrid.

On a different note we remind ourselves of the complexity and spread of the business environments in which we operate and consider one of the current phenomena – dealing with data in the Cloud.

Given the reality and choice confronting business to either be in, or plan to place and share their data in the Cloud, we take a timely look at the realities versus the myths. The consensus is that Cloud is here to stay and should, and is, being embraced as an enabler of business. Our team considers that many of the previous risks with Cloud have been mitigated and managed as the sophistication and security of the offerings grow nationally and internationally. The nature of international regulation is becoming apparent and advice is critical.

We also cover the level 3 Conglomerates Group supervision and the Australian Exposure Draft on the proposed consolidation exemption for Australian investment entities.

This review is packed with the current regulatory reform agenda and our partners, directors and their teams would be pleased to talk through these and any other issues to assist you in making the most strategic choices for your business.

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The year ahead: regulatory focus in 2013

Amid the current flurry of domestic and international regulator activity, our Governance and Regulatory Consulting practice has taken a moment to step back and highlight some of the topics that are defining the 2013 financial services industry agenda

The theme of fast-paced regulatory change continues in 2013. In light of continued overseas instability and an ambitious reform agenda, there is a concerted effort by regulators globally to:

- Address the regulatory gaps and loopholes identified during the financial crisis
- Re-establish confidence in the financial system
- Focus on retail investor protection
- Promote local market transparency.

The financial services industry is, at the same time, having to make strategic business decisions to respond to regulatory changes without the certainty as to where the final regulations may land. The regulatory change topics discussed in this publication include:

1. Increased regulator enforcement activity and broader regulatory reach
2. Regulatory focus on investor protection
3. Making operational the capital and liquidity requirements
4. Cross-industry and cross-border regulatory harmonisation
5. Transformation of governance, risk and compliance
6. Increased scrutiny around outsourcing activities
7. Efficiency through offshoring activities
8. Increased quality and reporting of data
9. Implementing FATCA
10. Client monies: protection, segregation, quantum.

In the following we highlight each of these topics and discuss some of the challenges organisations may face in the not too distant future.

1. Increased regulator enforcement activity and broader regulatory reach

2012 saw an increasing trend in cross-border cooperation and heavy enforcement directives. Across the past 12 months, record financial penalties were handed to a UK based bank ($1.9bn) by the U.S. regulator for lapses in U.S. AML practices and by the UK FSA to a Swiss investment bank ($1.5bn) for London Inter-Bank Offered Rate (LIBOR) manipulation – evidence of the cross-border reach and heavy penalties that regulators can apply for malpractices.

A key consideration of many domestic organisations will be the application of extra-territorial laws and regulations across the Asia Pacific region. This will create a number of strategic regulatory challenges for entities operating different regulatory models across geographies.

In Australia, there will be continued increased domestic regulatory supervision and enforcement activity across the current list of local directives; recent amendments to the *Mutual Assistance in Business Regulation Act 1992* allows Australian regulatory authorities greater flexibility in responding to extra-territorial regulator requests and facilitates greater cooperation between regulators globally. The challenge for organisations is to be able to make sense of the future regulations and to respond in a coordinated, customer focused way.

See August 2012 Risk & Regulatory Review – Getting the Balance Right - LIBOR on page 14

2. Regulatory focus on consumer protection

We have seen increasing examples of regulators targeting the financial advice industry through both enforcement and reform with the intention of lifting the standard of advice and safeguarding retail consumers. In the UK, the FSA has drawn focus on the fair treatment of customers (Treating Customers Fairly initiative) and Client Suitability requirements while domestically the Future of Financial Advice (FoFA) reforms aim to significantly alter priorities and behaviours of advice groups and advisors.

See our ASIC update on FOFA on page 37

3. Making operational the capital and liquidity requirements

Implementation of Basel III capital and liquidity rules will be front of mind in 2013. The Basel Committee of Banking Supervision recently announced a revision to Liquidity Coverage Ratio (LCR) rules with a proposed implementation timeline over 4 years from 2015 and a widening of the definition of High Quality Liquid Assets (HQLA). Basel III capital rules became effective 1 January 2013 in Australia, however APRA has yet to communicate its plan on the proposed changes.

See the article on Basel III: Introducing global liquidity standards on page 6

4. Cross-industry and cross-border regulatory harmonisation

There is increasing international and domestic evidence of regulatory harmonisation, a trend we expect to continue in 2013 and beyond. Initiatives such as the Undertakings for Collective Investment in Transferable Securities (UCITS) framework and EU passporting rights which allow financial organisations in EU member countries to work across EU member states while being regulated within one member state, as well as APRA's Level 3 conglomerates framework - effective 1 January 2014 – all indicate the regulatory appetite to minimise regulatory complexity across industries and across borders. The Australian Federal Government's 2012 White paper *'Australia in the Asian Century'* is a further indication of the commitment to review the traditional cross-border regulatory barriers with the intention of unifying and simplifying regulation across the Asia-Pacific region.

5. Transformation of governance, risk and compliance

There will be continued focus on increasing the effectiveness of governance, risk and compliance frameworks as organisations assess how to effectively embed the 'three lines of defence' concept whilst efficiently addressing regulatory change. Those organisations which embrace culture change programs and appropriate reward and consequence management systems will stay ahead of the pack. Earlier this year, the FSA released its guidance on the structure of sales incentive schemes, and globally we expect to see further developments in this area in line with safeguarding consumers against mis-selling. With ASIC increasing its focus on effective risk management, and APRA calling for explicit requirements for risk appetite frameworks for superannuation, risk remains a hot topic.

See April 2012 Risk & Regulatory Review – Stand & Deliver

6. Increased scrutiny around outsourcing activities

Outsourcing continues to be an increasingly viable option for a number of financial organisations looking for alternative ways to reduce costs and extend enterprise capabilities. As more services and programs are outsourced, global regulators will have a more influential role and increased interest in outsourcing activities. In Canada the Investment Industry Regulatory Organisation of Canada (IIROC) recently proposed rules regarding the general maintenance records as part of outsourcing arrangements. In Australia, APRA is requesting detail of the due diligence on offshore investment managers, prior to appointment. In March 2013, the Accounting Professional & Ethical Standards Board (APESB) also released GN 30: Outsourced Services which provides guidance to members in public practice on providing or utilising outsourced services.

See our APRA updates on page 41

7. Efficiency through offshoring activities

Many entities continue to look offshore as a means to take advantage of more cost effective operating models. In December 2012, APRA released Draft Prudential Practice Guide PPG 235 – Managing Data Risk – which outlines its preliminary expectations for entities which keep data outside the jurisdiction to which it relates. The regulator suggests entities adopt a 'cautious and measured approach' when offshoring data and that they fully consider the risks associated with retaining data overseas. The *Privacy Amendment (Enhancing Privacy Protection) Act 2012* also imposes significant new obligations on private and public sector organisations to disclose whether they reveal personal information overseas and if so to which countries. Where those countries have at least substantially similar privacy protections to Australia, organisations will have to get the informed consent of their clients. The amendments will commence in March 2014.

8. Increased quality and reporting of data

In 2013, we will see an increasing regulatory interest in reviewing and ensuring the integrity of data. Firms overseas are, in some cases for the first time, being required to provide their regulators with increased volumes of timely, high quality and accurate data. Data governance and infrastructure processes are coming into focus with a particular emphasis on risk data aggregation capabilities. Domestically, the focus appears to be on staff awareness, data life-cycle management, outsourcing/offshoring data management, data validation and assurance activities.

See our coverage of the APRA draft Prudential Practice Guide (PPG 235 Managing Data Risk) for managing data risk on page 42

9. Implementing FATCA

With the release of the final FATCA regulations and an Australian intergovernmental agreement (IGA) still being negotiated (but intended to be signed during 2013), financial services entities are progressing work on implementing FATCA despite no specific Australian guidance. For larger institutions with international operations and investments (or clients) there may be significant effort required to enhance core operations and IT screening, governance policies and protocols and systems.

See our article on FATCA – the road ahead on page 18

10. Client monies – protection, segregation, quantum

Protecting client monies is a key regulatory obligation in many jurisdictions, and in complex organisations with large transaction volumes, it can be a challenge to stay on top of it. In late 2012, a large UK asset manager was fined £9.5m for failing to take reasonable steps to segregate over £1b of client monies. This recent fine follows on from fines of £33m and £1.1m handed down by the FSA in 2010 and 2011 to other large asset managers for client money regulatory breaches. In its report 316: *Review of client money handling practices in the retail OTC derivatives* sector, ASIC found a number of weaknesses in client money practices, including:

- Failure to properly designate client accounts as trust accounts
- Inadequate segregation of duties
- No formal escalation process for reconciliation issues.

Staying on top of regulatory compliance and in control

We have seen some exceptional domestic and international regulatory developments within the sector recently and expect that trend to continue in 2013 and beyond. With unprecedented regulator reach and enforcement activities – ASIC entered into 18 enforceable undertakings in 2012 and a further seven in January 2013 – it is important that organisations maintain pace with local and overseas regulators which continue to 'raise the bar' with their expectations.

As 'regionalisation' gathers momentum in the Asia Pacific area it is important that emerging trends from overseas regulators are considered and factored into the strategic risk outlook. Finally looking internally, organisations should be ensuring a focus on growing and maintaining an effective risk culture, underpinned by quality processes and controls to effectively leverage technology and outsourced relationships.

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Basel III and the introduction of global liquidity standards

Treasury and Capital Markets Director Fridrich Housa looks at the impact of an internationally harmonised global liquidity standard under Basel III

The Basel III framework (the global regulatory standard on bank capital adequacy, stress testing and market liquidity risk) was developed in response to the deficiencies in financial regulation revealed by the Global Financial Crisis. It is being implemented this year through to 2019. However, capital requirements alone are not sufficient to promote sound risk management. Basic principles of liquidity risk management reinforced through robust supervisory standards are equally important.

This is where introducing internationally harmonised global liquidity standards as a minimum requirement under Basel III will have a major impact. Its aim is to improve the liquidity of the banks and reduce the risk of insolvency. This will be the first time global liquidity standards have been introduced and they are likely to have an impact on the funding structure of banks across the globe – certainly influence their deposits products' pricing – and potentially their profitability.

Liquidity framework

The core of the liquidity framework consists of two ratios which have been developed to achieve two separate but complementary objectives:

- The Liquidity Coverage Ratio (LCR) is intended to promote resilience against potential liquidity disruptions over a 30-day horizon (short-term stress scenario) with sufficient high quality liquid resources
- The Net Stable Funding Ratio (NSFR) requires a minimum amount of stable sources of funding at a bank relative to the liquidity of the assets and the potential for contingent liquidity needs from off-balance sheet commitments over a one-year horizon. The aim of this ratio is to promote medium and long term resiliency.

In addition, the framework also introduces four metrics for liquidity monitoring, such as contractual maturity mismatch, funding concentration, available unencumbered assets and market-related monitoring tools. The original schedule introduced an observation period from 2011 leading to introduction of LCR in 2015 and NSFR in 2018 however this was recently changed with phased approach to LCR as detailed further below.

Liquidity Coverage Ratio (LCR)

LCR is calculated as the ratio between stock of High Quality Liquid Assets (HQLA) and net cash outflows over a 30-day horizon (i.e. cash flow perspective). The framework requires LCR to be equal to or above 100%. HQLA are calculated as market value multiplied by asset factor for individual levels, with cash, central bank reserves, marketable securities issued or guaranteed by sovereigns, central banks and domestic sovereign debt assigned a factor of 100%.

Generally, the characteristics taken into account to set the HQLA are as follows:

- **Fundamental characteristics** – low market and credit risk, ease and certainty of valuation, listing on a developed exchange
- **Market characteristics** – active and sizeable market, 'safe-haven' assets, eligible for repurchase agreements with central banks
- **Operational requirements** – unencumbered and freely available.

	Outflows						Inflows
	Deposits	*Unsecured wholesale funding*	*Committed credit/liquidity facilities*	*ABS/ABCP*	*Secured wholesale funding*	*Collateral derivatives*	*Various*
Retail Customers	Stable: 5% Less stable: 10%		5%	100%	Central bank/Level 1 collateral: 0% Any counter-party/Level 2A collateral: 15% Level 2B eligible RMBS collateral: 25% Other Level 2B collateral: 50% Other collateral: 100%	Collateral calls: 3 notch downgrade Valuation changes non-Level 1 collateral: 20% Collateral liquidity needs: 100%	Level 1: 0% Level 2A: 15% Level 2B RMBS: 25% Other Level 2B: 50% Other: 100% Derivatives: 100%
SME		Stable: 5% Less stable: 10%					
Non-Financials, sovereigns		40%	Credit: 5% Liquidity: 30%				
Financial Institutions		100%	Credit: 40% Liquidity: 100%				
Other		100%	100%				

Figure 1:

Summarised overview of assets categories:

Level 1 assets: cash, central bank reserves, qualifying government bonds (0% standardised risk-weight under Basel II), etc.

Level 2A assets: government bonds (20% standardised risk-weight under Basel II), qualifying corporate bonds and covered bonds with credit rating AA- and above

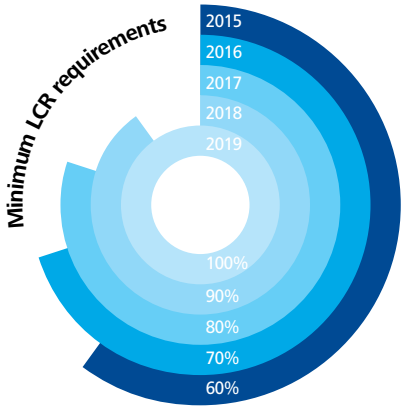
Level 2B assets: qualifying RMBS (credit rating AA and above) and corporate bonds (credit rating between A+ and BBB-), qualifying common equity shares

Figure 1. Source: Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, Basel Committee on Banking Supervision, January 2013

Cash outflows and inflows over a 30-day horizon are calculated using run-off factors summarised above, where the outflows are categorised according to type of instrument/funding, counterparts, stability, existence of operational relationships and collateral. *See Figure 1.*

The Basel Committee on Banking Supervision (BCBS) has issued the full text of the revised Liquidity Coverage Ratio (LCR) following endorsement on 6 January 2013 by its governing body - the Group of Central Bank Governors and Heads of Supervision (GHOS).
The revisions to the LCR incorporate amendments to the definition of high quality liquid assets (HQLA) and net cash outflows. In addition, the Basel Committee has agreed a revised timetable for phase-in of the standard and additional text to give effect to the Committee's intention for the stock of liquid assets to be used in times of stress. Once the LCR has been fully implemented, its 100% threshold will be a minimum requirement in normal times. During a period of stress, banks would be expected to use their pool of liquid assets, thereby temporarily falling below the minimum requirement.

The GHOS agreed that the LCR should be subject to phase-in arrangements (see diagram below) which align with those that apply to the Basel III capital adequacy requirements.



The definition of high quality liquid assets (HQLA) (the numerator) was expanded to include, for example, equities and mortgage-backed securities (subject to more conservative haircuts and a limit of 15% of total HQLA). The net cash outflow calculation (the denominator) was also revised; rates were reduced for some insured retail and corporate deposits, and committed liquidity facilities, and additional derivative risks were included.

The BCBS will conduct further work on the interaction between the LCR and the provision of central bank facilities over the coming year. Changes introduced level 2B which include lower rated corporate bonds, residential mortgage-backed securities and equities that meet certain conditions. Level 2 assets may not in aggregate account for more than 40% of a bank's stock of HQLA. Level 2B assets may not account for more than 15% of a bank's total stock of HQLA.

Also, the standard requires that, except in a situation of financial stress, the value of the ratio be no lower than 100% (i.e. the stock of HQLA should at least equal total net cash outflows). Banks are expected to meet this requirement on an on-going basis and hold a stock of unencumbered HQLA as a defence against the potential onset of liquidity stress. During a period of financial stress, however, banks may use their stock of HQLA, thereby falling below 100%.

In Australia, however, APRA may not widen the definition of HQLA, as chairman John Laker told a Senate Committee on 14 February: 'The discretion to add additional assets is qualified by the fact that these assets… must have a proven record of a reliable source of liquidity in markets even during stressed market conditions'. It appears that APRA will be looking at how the other classes of assets such as residential mortgage-backed securities (RMBS) performed during the Global Financial Crisis before deciding whether the HQLA will be revised.

Net Stable Funding Ratio (NSFR)

NSFR is calculated as the ratio between the amount of available funding (liabilities and equity) and required funding (to fund the assets) over a one-year horizon (i.e. balance sheet perspective). The NSFR is also required to be equal to or above 100%. Stable funding for the purposes of NSFR calculation is defined as those types of equity and liabilities expected to be reliable sources of the funds under an extended stress scenario of one year.

For determination of the required funding amount, accounting and regulatory treatment is irrelevant – the required funding amount depends solely on the characteristics of the respective instrument's liquidity, which in turn determine Available or Required Stable Factor (ASF/RSF). ASF factors define the amount of assets that would be expected to stay with the institution for an extended period in an idiosyncratic stress event – partly applies to assets with effective maturity < 1 year.

RSF factors approximate the amount of a particular asset that could not be monetised during a liquidity event lasting one year – the higher the availability under stress the lower the RSF factor. We have summarised the factors opposite:

	ASF categories *(numerator)*	*Factor*
1	• Total amount of capital, including both Tier 1 and Tier 2 • Preferred stock not included in Tier 2, effective maturity > 1Y (without embedded option) • Total amount of secured and unsecured borrowings and liabilities > 1Y.	100%
2	• Stable retail/SME deposits < 1Y.	90%
3	• Less stable retail/SME deposits < 1Y.	80%
4	• Unsecured wholesale funding and deposits provided by non-financial corporate customers < 1Y.	50%
5	• All other liabilities and equity categories.	0%

	RSF categories *(denominator)*	*Factor*
1	• Cash, money market instruments • Securities, loans to financial entities, effective maturity < 1Y.	0%
2	• Specific unencumbered government/ quasi-sovereign bonds with excellent rating, active repo-markets, > 1Y.	5%
3	• Off B/S credit and liquidity facilities.	5%
4	• Specific unencumbered corporate bonds or covered bonds with excellent rating, active and liquid markets, 1Y.	20%
5	• Gold, loans to non-financial corporate clients > 1Y etc.	50%
6	• Residential mortgages, qualifying for Basel II 35% risk wght.	65%
7	• Loans to retail clients, <1Y.	85%
8	• All other assets.	100%
9	• Other Off B/S items (letters of credit, guarantees, non-contractual contingent funding obligations).	tbd*

* National supervisors can specify the RSF factors based on their national circumstances

Figure 2.

Source: Basel III: International framework for liquidity risk measurement, standards and monitoring, Basel Committee on Banking Supervision, December 2010

'BCBS is currently reviewing the NSFR, however it remains the Committee's intention that the NSFR will become a minimum standard by 1 January 2018.'

Regulators' impact assessment studies

Quantitative impact assessment study produced by the Committee of European Banking Supervisors (CEBS) in December 2010 concluded that the new liquidity standards would result in an average liquidity coverage ratio of 67% and 87% for Group 1 (banks with Tier 1 capital in excess of €3 billion, well diversified and internationally active) and Group 2 (other) banks, respectively. The average net stable funding ratio would be 91% and 94%, respectively.

The Bank for International Settlements (BIS) impact assessment study released in September 2012, based on December 2011, indicated the weighted average Liquidity Coverage Ratio (LCR) for Group 1 banks would have been 91% (compared to 90% for 30 June 2011) while the weighted average LCR for Group 2 banks was 98%. The weighted average Net Stable Funding Ratio (NSFR) is 98% for Group 1 and 95% for Group 2 banks.

Based on results of the Basel III monitoring exercise as of 30 June 2012 released in April 2013, 51% of the monitored banks already meet or exceed the minimum NSFR requirement, compared to 46% at the end of June 2011 and 51% at the end of December 2011, with 90% at a NSFR of 75% or higher as at 30 June 2012.

A comparison between the BIS and the CEBS study indicates that European banks have on average a lower LCR and NSFR ratio.

- *In Australia, APRA conducted a quantitative impact study on Australia's six largest listed banks.* Unlike capital, the Australian banking system was historically more vulnerable due to its reliance on wholesale foreign funding. Charles Littrel, Executive General Manager, Policy, Research and Statistics at APRA, estimated that the larger banks were running at about 31% on LCR, before taking into account the RBA's liquidity facility.

On the other hand, it was expected that banks would improve their liquidity through the growth of retail term deposits. It is expected that they will start coming up with LCR-specific products, such as 31 day call deposits. The main concern was the expected short-fall in the collateral necessary to back the RBA's facility. This was addressed by allowing banks to include self-securitisation as eligible collateral.

As per draft APS 210 (Liquidity) from November 2011, ADIs which are subject to the Minimum Liquidity Holdings (MLH) regime will be required to maintain a minimum holding of 9% of their liabilities in specified liquid assets. The main challenge in Australia according to APRA's Charles Littrel is that there are clearly insufficient government bonds and other non-bank high quality bonds to meet the LCR for Australian dollar denominated outflows.

Therefore the draft of APS 210 allows a scenario analysis ADI (i.e. other than MLH regime) to establish a secured committed liquidity facility (CLF) with RBA to cover any shortfall (in AUD) between an ADI's HQLA and the LCR requirement. Qualifying collateral would be assets eligible for repurchase transactions with the RBA under normal market conditions, and any other assets nominated by the RBA.

Australian banks' Net Stable Funding Ratios were in a more favourable position than their Liquidity Coverage ratios, with the six largest banks having an 80% NSFR in 2011, which, given a maintained pattern of deposit and credit growth, is expected to be almost 100% by the time their NSFRs become effective in 2018.

Expected impact on banks

The new liquidity risk minimum requirements are expected to influence both internal processes in the banks as well as impacting upon the business model.

Organisational impact predominantly means:

- External reporting supplemented by the new liquidity ratios
- Preparation of a cash flow-based liquidity gap profile including categorisation of cash outflows inflows
- Extension of existing IT systems in order to ensure the required granularity of data
- Monitoring tools – regular reporting to the supervisory authorities
- Possible integration of the supervisory reporting standards into the internal liquidity risk management system.

The impact on the business model is important as it will in turn impact upon the pricing of banking products and thus on customers. The main impacts will be:

- Reduced dependency on capital markets in favour of retail funding
- Longer maturities and higher stability of liabilities
- Reduced term transformation and higher costs for refinancing
- Low-yield securities for the liquidity buffer will reduce the profitability of the banking sector
- Lending becomes more expensive as costs are shifted to borrowers
- Alternatively there will be a reduction of RoE if the costs are shifted to owners
- Issuing LT debt in order to meet NSFR requirements.

Expected impact on depositors

As outlined in Figure 1, retail deposits are treated more favourably than wholesale funding from financial institutions given their more stable nature. This is in addition to generally increased demand from Australian banks for retail deposits to decrease their vulnerability and over-reliance on wholesale funding.

A possible local impact in Australia would be SMSFs that would have been treated more favourably for the purposes of LCR calculation – being 'retail' deposits – compared with institutional funds which would have been treated as financial institutions and so attract the highest asset run-off factor of 100%. To address this, APRA in its draft of APS 210 included the possibility that funds placed by the natural person with an intermediary who then places those funds with an ADI can be treated as retail deposits if certain conditions are met.

Another flow-on impact of the liquidity reform will be the introduction of deposit products on a rolling basis with maturity over 30 days to achieve more favourable treatment under the new regime. Such deposits with run-off over 30 days would not be included in cash outflows for the calculation of LCR and so would not be required to be covered by HQLA with lower returns.

Also financial markets will be impacted, such as steeper yield curves due to an increase in demand for instruments at the long-end, lower yields for instruments qualifying as a part of the liquidity buffer, and LCR used to fund government budget deficits post GFC.

Final word

The new liquidity rules are likely to increase interest rates and reduce available liquidity in the interbank money market, which in this environment of increased demand for deposits will put another pressure on interest margins.

With increasing pressures to delay the implementation of Basel III requirements across Europe and US, it will be important to maintain the competitiveness of Australian banks compared to their overseas counterparts, while increasing their liquidity resilience.

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Managing systemic and contagion risk: Level 3 conglomerates group supervision

Given recent and impending global regulatory developments, as well as mooted changes by APRA to the Level 3 conglomerates framework, Financial Services Risk Director Wendy Yip looks at the need for financial institutions to transform how they preserve sustainable earnings while responding to and managing risk

Organisations can create greater efficiencies and effectiveness in developing a sustainable risk management program through a single, integrated, and globally centralised platform for improvements to data accuracy and accessibility.

Level 3 Conglomerates group supervision

Against the backdrop of continued economic uncertainty in Europe and elsewhere, steps are being taken in a number of jurisdictions to restructure the banking sector with the aim of reducing risk or supporting the swift and effective resolution of banks in distress.

The main approaches include 'ring-fencing' (found in the UK and other EU countries) and full structural separation of certain banking activities from core banking activities (the Volcker Rule, as part of the Dodd-Frank Act). The key driver of such regulations is the management of systemic risk and contagion risk.

While the structural reform of the banking sector is less prevalent in Australia, APRA has responded by releasing a consultation paper on the long-awaited amendments to the Level 3 conglomerates framework.

Conglomerate groups (containing APRA-regulated entities) are institutions which have material operations in more than one APRA-regulated industry and/or have one or more material unregulated entities.

Background

In March 2010, APRA invited discussion for proposed changes to the supervision of conglomerate groups i.e. the 'Level 3 framework'. This has four components: group governance; risk exposures; risk management; and capital adequacy. The key supervisory objectives are as follows:

- Assessing and understanding complex group structures
- Forming a consistent view of the capital position across complex groups – the consolidation and deduction approach is not considered sufficient
- Identifying intra-group transactions and exposures, double gearing and/or excessive leverage
- Obtaining a clear view of governance and risk management for non-APRA regulated entities.

The current consultation paper, published in late December 2012, focuses on responses regarding the first two components; that is, requirements for group governance and risk exposures. APRA will release a separate paper in 2013 outlining requirements for risk management and capital adequacy.

The Level 3 framework, with a planned effective date of 1 January 2014, complements existing Level 1 and 2 industry-based supervisory frameworks by guiding the supervision of risks not captured within either of these frameworks.

The introduction of the Level 3 framework will address four overarching requirements:

- A robust governance framework must be applied through the Level 3 group
- Intra-group exposures and external aggregate exposures must be transparent and prudently managed
- There must be an effective group-wide risk-management framework
- There must be sufficient capital to support risks (including material risks from non-APRA-regulated activities) that could affect the entire group.

Group governance requirements

APRA proposes to extend its current standards for 'governance', 'fit and proper', 'outsourcing' and 'business continuity management' that apply to Level 1 and 2 groups to Level 3 Head Entity groups and Level 3 groups more generally.

Beyond the Level 3 framework, APRA also intends to propose changes that would require Level 2 groups to establish group-wide policies for governance, fitness and propriety.

APRA is expected to propose changes to the four cross-industry behavioural standards to align with recently released behavioural standards for superannuation. This change would affect all Australian Deposit-taking Institutions, general insurers and life insurers on a Level 1 basis, Level 2 groups and Level 3 groups.

Aggregated risk exposure and intra-group transactions/exposures requirements

Key requirements around risk exposure and intra-group transactions/exposures are:

- Adequate systems and controls in place to identify and manage aggregate risk exposures as well as intra-group transactions/exposures across the Level 3 group
- Implementation of a group-wide aggregate risk exposures policy, with limits
- Implementation of systems and policies to manage intra-group transactions/exposures across the group.

For these prudential requirements, APRA may also impose limits or adjustments to the Level 3 group if it believes the group is exposed to significant or excessive risks/intra-group transactions and exposures.

Key considerations for conglomerates

Financial institutions are seeking to remain competitive while maintaining high levels of capital and driving down costs. At the same time, regulatory agencies are introducing more stringent capital requirements, compelling the industry to rethink and reorganise existing business models, governance processes and risk-management capabilities.

Complex financial organisations have witnessed diminishing margins with their current business models, encouraging them to focus on more specific areas of geographical markets, introduce new products and explore strategic acquisitions in core business lines as a means to maintain strong and sustainable earnings.

In this context, financial institutions need to transform the way they respond to and manage risk without sacrificing sustainable earnings. Managing risk is about taking steps to protect capital while meeting core business needs across the organisation. Risk is a core management discipline, and access to timely and reliable data has become even more essential for decision-making in the current regulatory climate. The primary areas of emerging risk include outsourcing risks and business continuity management.

By responding with a single, integrated, and globally centralised platform that improves data accuracy and accessibility, and enables system applications, organisations can create greater efficiencies and effectiveness in developing a sustainable risk management program. The key data challenge includes identification of intra-group exposures across counterparties, industry sectors and geographies.

This also presents an opportunity to consider simplification of an organisation's business and legal structure and address the question of what is the most efficient operating model to achieve its long-term strategic objectives.

A lack of coordination within conglomerates will result in redundancy, overlap and an increased burden on the business. In times of scarce capital, funding and liquidity, the lack of agility may make or break the financial institution.

For an overview of the detailed changes, please see our update titled, APRA releases response to conglomerate group supervision on page 41.

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The Cloud: reality vs. myth and thinking differently

When people think about Cloud, they typically consider cost benefits and IT. Deloitte Risk Partner Alastair Banks and Deloitte Digital Partner Kevin Russo show the reality of Cloud as a business enabler

As the use of the Cloud grows globally from $40.7 billion in 2011 (Forrester) to $130b in 2015 (Gartner) and expected to be $241b in 2020 (Forrester), there are very few organisations today that do not use or are not planning to use the Cloud. In Australia in 2011 Cloud usage was $732m (Forrester), in 2020 it is predicted to be $3.2 billion (Forrester).

It isn't really a choice of whether you are in the Cloud or not – the decision is more about how to use the Cloud better to run your business, to access new capabilities, new innovations and, new technologies and, where appropriate, to enable business transformation.

Myth 1

Companies are moving to the Cloud to save money

Reality: Companies are moving to the Cloud for agility and flexibility, and speed to market.

- It can cost money to transition, but the Cloud primarily changes the profile of the spend.

Myth 2

Regulatory and privacy concerns prevent organisations using offshore Cloud providers

Reality: Australia's current and future legislation allows data to be moved outside its territory, subject to certain disclosure requirements.

- Reasonable steps should be taken to ensure data is protected to meet Australian requirements
- Privacy laws in most countries around the world provide protection for personal identifiable data and require notification when data is disclosed.

Myth 3

If you use an onshore Cloud provider your data won't leave the country

Reality: Your data doesn't have to leave the country if you don't want it to – it is entirely up to you to negotiate this with the vendor

- There is more capability onshore in Australia from both local and global players
- There is an increasing recognition on where the data is encrypted rather than where it is stored. And who has access to it.

Myth 4

The Cloud is purely a place to store data

Reality: Absolutely not, moving to the Cloud is much more than just data hosting

- It is primarily about accessing scalability, agility and new business processes
- It can be about reengineering the way of doing business, accessing new business channels, different skills and opportunities.

Myth 5

The Cloud will make the CIO redundant and replace the IT Department!

Reality: The job description and the value of the CIO and IT Department will evolve.

- The IT Department. will become more of a service broker than a service builder
- The Cloud gives IT the opportunity to better redefine itself and its unique skill sets
- The Cloud gives the CIO and IT Department the ability to anticipate and innovate for the business.

Myth 6

Cloud solutions are plug and play

Reality: Work needs to be done to integrate Cloud solutions with existing IT systems.

- Some Cloud solutions are Plug and Pay – the real value comes when Cloud is integrated with other services and business functions
- The integration and brokering market of the Cloud is quite immature.

Myth 7

Cloud solutions are less secure

Reality: Many Cloud providers have better security than most organisations because of the economies of scale of their business.

- Cloud service providers focus on security as part of their core business
- They can hire the world's best talent
- Like any prudent business, an organisation needs to gain assurance and to continue to monitor the service.

Myth 8

Once with a Cloud provider you don't need to worry about business continuity issues

Reality: You cannot delegate business continuity planning to any external vendor.

- You need to understand what solutions and service levels the Cloud is providing
- You need to develop your own business continuity solutions with your Cloud provider.

Myth 9

Cloud will still mean having to lock-in one provider

Reality: With the Cloud it will be easier to switch vendors as the distinction between data and software becomes clearer.

- For the Cloud to work effectively intermediaries will be needed to enable switching.

Myth 10

Cloud is a technology issue

Reality: No. Cloud is a business value creator.

- It is a strategic differentiator and a disruptor
- You can do new things with Cloud. For example Jetstar uses the Cloud to offer customers a one-stop for all travel needs. Through a public Cloud it provides customers with hotel options. Its portal provides the agility and flexibility to expand alongside their customer needs and was deployed in months, as opposed to years.

Last words

Flexibility and enablement:

With the Cloud's flexibility there are possibilities that on-premises solutions do not enable. The Cloud provides different business model possibilities, and different ways of involving multiple parties within an ecosystem.

Internal private Cloud and the external public Cloud are no longer the only available options. Hybrid Clouds are now coming of age with capabilities and services that allow organisations to distribute their workloads to a Cloud environment that best suits their security, privacy and budget.

Organisations will be empowered to build Clouds that meet their business models and not the other way around.

The Cloud enables multiple solutions, different points of integration, mobility, social collaboration and networking. It enables networking between the organisation, groups of vendors, business partners, and customers.

Deloitte Risk Services partner Alastair Banks, along with Consulting partner Kevin Russo leads an exciting Australian Cloud practice which provides end-to-end Cloud strategy and transformation services to Cloud providers and subscribers. The team uses a detailed playbook to accelerate and guide strategy, build architecture which incorporates design thinking, as well as implement Cloud services. As the nature of international regulation is becoming apparent, knowing how to navigate is critical.

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FATCA – the road ahead

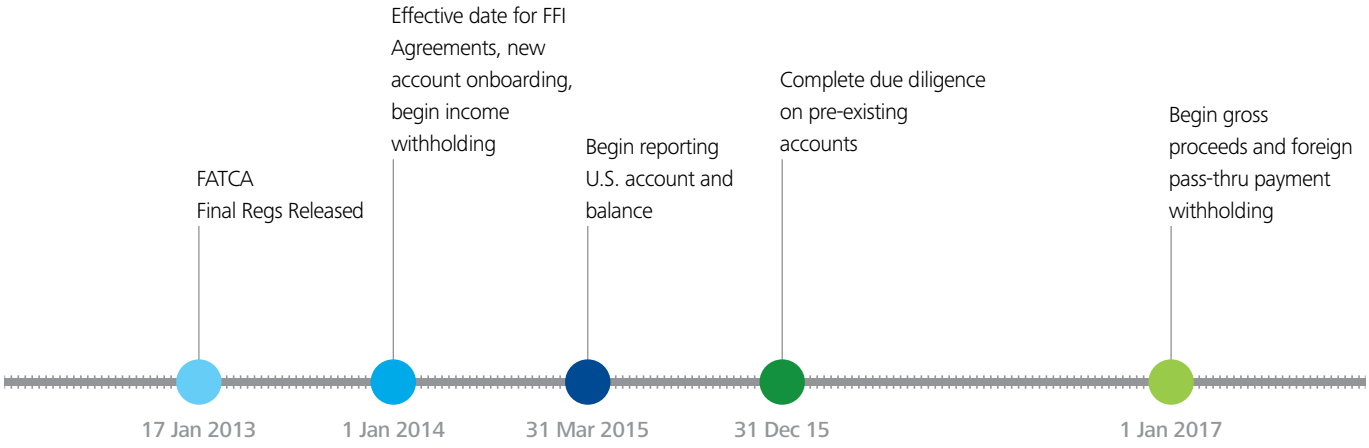
Following release of the final FATCA regulations, FATCA Lead Director Alison Noble sets out key changes, compares the requirements and provides a road map for Australian financial institutions over the next nine months

On 17 January 2013, the U.S. Treasury Department and IRS released 544 pages of supplementary information and final regulations for the Foreign Account Tax Compliance Act (FATCA).

These final FATCA regulations are a culmination of the series of interim guidance issued by the U.S. Treasury Department and IRS, including a series of IRS Notices, the proposed regulations released on 8 February 2012, and Announcement 2012-42 released in October 2012.

To develop a streamlined approach to FATCA implementation, the U.S. Treasury Department and IRS solicited and received numerous comments and met extensively with industry stakeholders (including the Australian Treasury and Australian industry associations representing different parts of the Australian financial services industry). The final regulations take into account those comments and consultations limiting the institutions' obligations and accounts subject to FATCA, and setting out detailed guidance for the implementation of FATCA.

Final regulations: new FATCA timeline



Agreements, documentation and due diligence

FFI Agreements

- Details substantive requirements that will be included in the FFI Agreement when published.

Responsible Officers

- Outlines the certification requirements that must be followed by Responsible Officers.

Account identification and documentation

- Allows the use of certain forms prepared and completed in foreign languages
- Reinstitutes the 'eyeball test' to rely on documentary evidence in lieu of Form W-9
- Allows reliance on pre-FATCA Forms W-8 and written statements
- Permanent validity of documentation, unless change of circumstance
- Ability to cure inconsequential errors in withholding certificates
- Reliance on same documentation for multiple accounts held by same account holder and new accounts of existing account holder can be pre-existing accounts
- Allows for reliance on information provided by third-party credit agency in certain circumstances
- Incorporates standards of knowledge for FFIs consistent with U.S. withholding agents.

Definitions

Investment entity FFIs

- Adopts the definition introduced in the IGA
- Excludes many smaller entities that are not professionally managed and includes other entities such as investment advisors and asset managers.

Depository institution FFIs

- Narrows the definition to generally exclude entities such as finance companies that do not fund operations with deposits and entities acting as networks for credit card banks that hold cash collateral from such banks.

New FFI category

- For certain holding companies and treasury centres that include an FFI in their group or are formed in connection to or availed by investment vehicles such as collective investment vehicles, mutual funds, hedge funds, venture capital funds, etc.

Accounts and account holders

- Clarifies the account holder for insurance and annuity contracts
- Clarifies scope of depository accounts (e.g. includes credit balance on a credit card)
- Changes to the definition of excepted retirement and pension accounts (e.g. removes requirements for source of contributions).

Deemed-compliant FFIs and exclusions

New registered deemed compliant statuses

- Qualified credit card issuers
- Sponsored investment entities and controlled foreign corporations.

New certified deemed compliant statuses

- Sponsored, closely held investment vehicles
- Limited life debt investment entities – available before 1 January 2017.

Retirement funds

- Now defined as exempt beneficial owners, with improvements to the definition.

Other improvements

- Clarifies the conditions to be satisfied
- Insurance companies, credit unions and investment entities can qualify as local FFIs
- Exemption for holding companies and treasury centres that are part of a non-financial group
- Certain passive entities not professionally managed are not FFIs
- Replaces exception for ordinary course of business payments with list of excluded non-financial payments.

Registration

FATCA registration portal - accessible no later than 15 July 2013:

- Model 1 FFIs will be registered deemed - compliant FFIs
- IGA FFIs can register as deemed-compliant provided the jurisdiction appears on the list published by the IRS as having in effect an IGA
- First GIIN List to be published on December 2, 2013 and then monthly
- FFIs must register by 25 October 2013 to ensure issuance of a GIIN by 31 December 2013 and inclusion on the IRS list of participating FFIs and registered deemed-compliant FFIs (including reporting Model 1 FFIs) on 2 December 2013.

New and updated forms

- Form W-8BEN-E (for entities) and Form W-8BEN (for individuals) to be released shortly
- New Form 8966 and revised Forms 1042 and 1042-S to be released later in 2013 or 2014.

Highlights of the final regulations

Importantly, the final regulations adopt the revised timeline included in Announcement 2012-42, which aligns the timing for phasing in FATCA obligations in the final regulations with the timing set out in the intergovernmental agreements (IGAs).

The final regulations contain numerous changes from the draft regulations – many provide additional detail for compliance with FATCA obligations. Other changes are more substantive. The following summary highlights some of the changes contained in the final regulations.

Interaction of the final regulations with IGAs

As outlined in our FATCA article in the December issue of *Risk & Regulatory Review,* Australia is progressing towards a Model 1 IGA on FATCA with the U.S. which will require all financial institutions resident in Australia (Australian FIs) to comply with a modified version of FATCA. Under a Model 1 IGA, Australian FIs that must report on U.S. accounts under the IGA will report to the Australian Taxation Office, which will then provide information to the IRS.

The final regulations will interact with an Australian IGA in a number of ways including:

- Australian FIs that comply with Australian laws to identify and report U.S. accounts will be treated as satisfying the FATCA due diligence and reporting requirements for FATCA
    - Australian FIs will generally not need to apply the final regulations for the purposes of complying with and avoiding withholding under FATCA
    - In certain cases prescribed in the IGA, Australian FIs may be able to elect to apply provisions of the regulations instead of the rules otherwise prescribed in the Australian IGA (although this requires the election to apply for each full set of provisions (e.g. pre-existing individual accounts))
    - The IRS and U.S. Treasury Department recently indicated that any definition that is available (or preferential) in the final regulations will also be available under an IGA
- The IRS currently contemplates that a Global Intermediary Identification Number (GIIN) may be used by reporting Model 1 FIs (such as Australian FIs) to satisfy reporting requirements under local law and is discussing this possibility with Model 1 IGA partners (and as part of the OECD's Treaty Relief and Compliance Enhancement (TRACE) program)
- The IRS is also discussing with partner jurisdictions the possibility of adopting a single format for reporting FATCA information. One of the key features of the TRACE program recently approved for implementation by the OECD is standardisation of reporting and documentation and efforts are underway to align requirements for TRACE and FATCA
- The Australian IGA, rather than the final FATCA regulations, will determine whether a resident entity described in the Australian IGA is an FFI.

Australian FIs with operations in jurisdictions outside of Australia may be dealing with variations of the Model 1 IGA, Model 2 IGA or the final regulations in those other jurisdictions. The following table compares the requirements under the Model 1 IGA, Model 2 IGA and the final regulations, with citations.

Comparison of IGA model agreements to final regulations

Issue	Model 1	Model 2	Final regulations
FFI agreements and general compliance			
FFI agreement	Not required for resident FFIs.	Resident FFIs must agree to comply with the requirements of an FFI agreement. Article 2(a).	Subject to specified exceptions, all FFIs must enter into an FFI agreement to avoid withholding. Requirement to withhold, on payments to FFIs, see Reg. §1.1471-2(a). FFI agreement described, Reg. §1.1471-4.
Amendment of agreement	Intended prior to 31 December 2016. Article 10.	Expected to be the same as Model 1.	Unknown.
Registration with IRS	Required. See, e.g., HMRC Guidance Notes, Section 2.1.	Required. Article 2(1)(a).	Required. Reg. §1.1471-4(a).
Enforcement of compliance	Local/IRS. Article 5.	Local/IRS. Article 4.	Internal compliance program; certifications; IRS. Reg. §1.1471-4(f).
Significant non-compliance	Must be resolved within 18 months. Article 5(2)(b).	Must be resolved within 12 months. Article 4(2).	Rules provided to cure event of default. Reg. §1.1471-4(g).
Deemed-compliant/exempt entities	Annex I(VI)(B)(4), and Annex II (by mutual agreement).	Annex I(VI)(B)(4), and Annex II (by mutual agreement).	Reg. §§1.1471-5(e)(5), -5(f), -6; Reg. §1.1472-1(c).
Can resident FFIs be non-participating FFIs?	Limited to cases of unresolved significant non-compliance. Article 5(2)(b).	Limited to cases of unresolved significant non-compliance. Article 4(2).	Yes
Due diligence and documentation			
Due diligence requirements	Annex I	Annex I	Reg. §1.1471-4(c).
Election to follow due diligence provisions of the regulations rather than Annex I	Yes. Annex I(I)(C).	Yes. Binding subject to material modification rule. Annex I(I)(C).	N/A
Permitted to open undocumented individual accounts	No, except for de minimis accounts. Annex I(III)(B).	No, except for de minimis accounts. Annex I(III)(B).	Yes, but subject to a limited cure period. Reg. §1.1471-5(g)(ii).
Permitted to open undocumented entity accounts	No; however, self-certification may not be required. Annex I(V)(B), (C).	No; however, self-certification may not be required. Annex I(V)(B), (C).	Yes, but subject to a limited cure period. Reg. §1.1471-4(c)(3)(ii).
Required closing of recalcitrant account holders	No. Article 4(2).	No. Article 4(2)(a).	Yes, as specified. Reg. §1.1471-4(i). Required reduction. Reg. §1.1471-4(g)(1)(ii).
Required to provide financial services to specified U.S. persons	Limited to small financial institutions with a local client base. Annex II.	Limited to small financial institutions with a local client base. Annex II.	Limited to certain deemed compliant FFIs. Reg. §1.1471-5(f)(1)(i)(A).

Issue	Model 1	Model 2	Final regulations
Reporting			
Resolution of conflicts of law to permit reporting	Yes	Yes	No
Reporting of information to local authority or IRS	Local Authority, Article 2.	IRS, Article 2.	IRS, Form 8966: U.S. accounts, Reg. §1.1471-4(d)(3)(vii); recalcitrant, Reg. §1.1471-4(d)(6)(v).
Information reporting requirements	Specified in agreement. Article 2.	Based upon regulations. Article 2.	Provided in Reg. §1.1471-4(d).
Reporting of U.S. accounts	Automatic for reportable U.S. accounts. Article 2(1).	Consent to report required from each U.S. account. Article 2(1).	Waiver required from each U.S. account, if reporting is prevented under foreign law. Reg. §1.1471-4(i)(2).
Reporting of recalcitrant accountholders	Automatic for reportable U.S. accounts. Article 2(1).	Treated as U.S. accountholders, total number and value to be reported, and subject to group request by U.S. Article 2(2).	Reg. §1.1471-4(d)(6).
U.S. reciprocity	Yes (reciprocal agreement only)	Optional	No
Withholding			
Resolution of conflicts of law to permit withholding	Yes. See, e.g., Article 4(1)(d).	Yes. See, e.g., Article 3(2)(b).	No
Withholding on resident FFIs	No, except in cases of unresolved significant non-compliance. Article 4.	No, except in cases of unresolved significant non-compliance. Article 3(1).	Yes, withholding applies to any non-participating FFI. Reg. §1.1471-4(b).
Withholding on non-resident, non-participating FFIs	Yes. Article 4(1).	Yes, subject to the withholding requirements of the regulations. Article 2(1)(a).	Yes, withholding applies to any non-participating FFI. Reg. §1.1471-4(b).
Withholding on foreign passthru payments and gross sales proceeds	No. Article 4.	No. Article 3.	Yes, 2017 at the earliest. Reg. §1.1471-4(b)(4).
Withholding on U.S.-source FDAP	No. Article 4.	No. Article 3.	Yes, begins in 2014, Reg. §1.1471-4(b).
Withholding on recalcitrant account holders	No. Article 4(2).	No. Article 3(2).	Yes. Reg. §1.1471-4(b).

A road map of 'must-haves' by 1 January 2014

Australian FIs will need to progress their FATCA projects during 2013 to meet the 1 January 2014 'go-live' date under either an Australian IGA or the final regulations. Even if an Australian IGA is signed shortly, it may be some time before detailed guidance for Australian FIs is provided via Australian legislation, regulation or ATO rulings. In the meantime, the final regulations, along with guidance from other Model 1 IGA jurisdictions (e.g. the UK) provide direction and assistance for FATCA implementation. Where Australian FIs may be able to elect to apply the final regulations rather than the rules prescribed in an Australian IGA, Australian FIs will need to be sufficiently familiar with those aspects of the final regulations to enable an informed decision as to whether such an election should be made or not.

With around nine months to go, Australian FI's should focus their FATCA projects on the following 'must-haves' that are required by 1 January 2014.

Entity classification
- Identify all FFIs in the expanded affiliated group
- Classify all entities for FATCA purposes, including deemed compliant entities.

Financial counterparty due diligence
- Understand and agree scope of responsibility with counterparties
- Due diligence on counterparties in 2013 to ensure timely compliance.

Withholding process (non-IGA)
- Must go-live with new account opening process
- Intermediaries must provide withholding allocation statements to withholding agents.

1 Jan 2014

New account opening process
- Required to go-live on 1 January 2014
- Obtain W-8s or other evidence from new account holders
- Cross-reference to AML and other account opening documentation requirements.

Compliance program initiated
- Must go-live with new account opening process
- Program designed to ensure compliance with FFI Agreement
- Monitor changes in circumstances to account holder documentation from 1 January 2014.

IRS registration
- Register by 25 October 2013 to ensure issuance of a Global Intermediary Identification Number by 31 December 2013
- Model I IGA FFIs to register as deemed compliant FFIs and can register even if IGA not ratified, provided the jurisdiction is on IRS list of IGAs.

FATCA implementation will impact Australian FIs differently and may require changes to systems, operational processes, due diligence of investment chains and management of relationships with counterparties and customers.

Australian FIs should begin – or continue to progress – FATCA projects to ensure that the 'must-haves' above are completed or in place by 1 January 2014

At a minimum, in the coming weeks, Australian FIs that have not done so already should determine whether they are in FATCA and, if so, classify the FI and related parties for FATCA purposes under the Model 1 IGA and final regulations. This analysis should be documented and dealt with in accordance with the FI's governance framework and, if required, a FATCA implementation project scoped and commenced.

Alison is Deloitte's FATCA Lead Director. With more than 13 years' experience in taxation consulting and compliance, Alison specialises in providing taxation services to clients in the financial services industry. She is a subject matter expert on FATCA and a member of Deloitte's FATCA leadership team in Australia and the Asia Pacific region.

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Superannuation snapshot: facing up to 2013 – the numbers do the talking

Actuaries and Consultants Superannuation Partners Wayne Walker and Stephen Huppert analyse APRA's 2012 fund statistics to provide a snapshot of Australia's $1.4 trillion superannuation industry as it faces up to a year of Stronger Super, MySuper, SuperStream, and the FOFA reforms

The breakdown of the $1.4 trillion at 30 June 2012 (according to the APRA Annual Report) in billions was:

Funds	Billions
Corporate	56.1
Industry	267.3
Public Sector	222.7
Retail	371.4
Other	42.2
SMSF	440.9
Total	**1400.6**

Note: The APRA statistics examined exclude the hundreds of thousands of primarily small self-managed super funds (SMSFs), and a small number of funds showing nil returns or in the process of winding up. See our SMSF article on page .

Funds competitively seek a differentiator

The 230 funds, representing 30 million member accounts, with more than $795 billion in net assets focused on here show that the FY12 shift from corporate and retail funds to industry funds has continued into FY13. And although industry fund account balances remain lower than their competitors, their growth in assets accelerated more than 6% over the previous year.

As the market continues to become more congested and market share reduces, the pressure to find a differentiator has increased. This has led to a wave of new lower cost products and we expect to see further, quite radical shifts in product design as the MySuper products are launched this year. Retail products, freed from embedded advisor fees, are now able to be much more aggressive competitors on price, as well as on services. Institutions are also actively looking at how to transition members into retirement income products – something that will become increasingly important as the population ages.

Funds are spending more on insurance

Insurance costs per member in industry funds increased by more than 20% in 2011/2012 and by more than 50% over the three years 2009 to 2012. A similar trend occurred with retail funds. Much of these increased costs can be attributed to increases in basic levels of cover and the introduction of more and more income protection policies. To offset these costs, Australia's largest industry and retail funds have worked hard to encourage their members to take out more insurance. Corporate funds, on the other hand, where comprehensive insured benefit programs have been a feature for many years, have had much lower increases.

Insurance premium per member

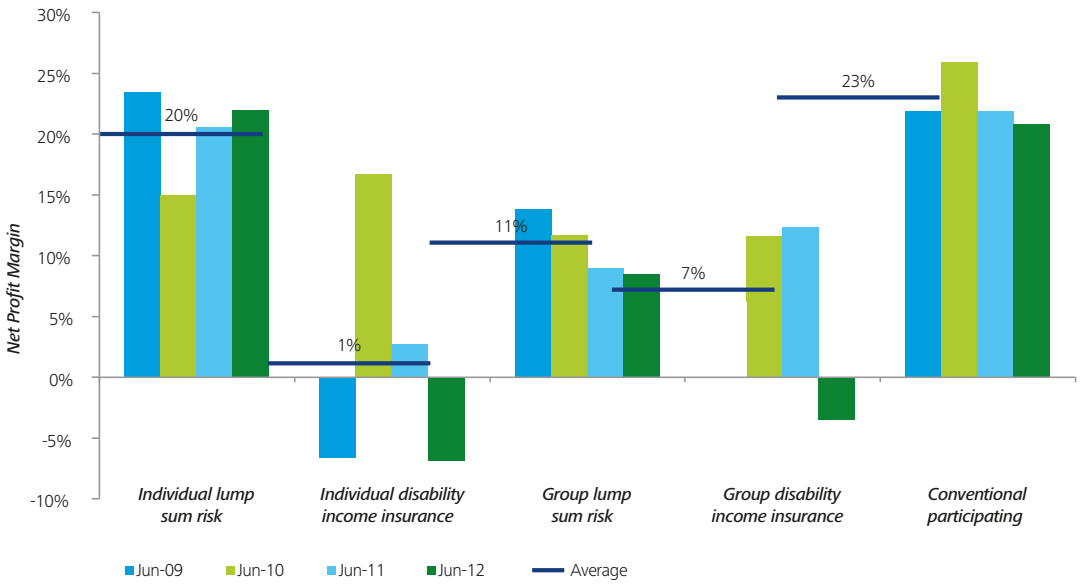
Year Ended 30 June	Industry funds $ pa	Retail funds $ pa	Corporate funds $ pa
2012	152	232	192
2011	126	195	157
2010	110	170	172
2009	99	156	165
2008	79	130	181
2007	68	115	172
2006	55	103	161
2005	50	91	155
2004	42	81	158

Source: APRA and Deloitte Actuaries and Consultants analysis 2013: APRA statistics also revealed that funds are spending more on insurance.

And funds are likely to also pay more

Group insurance profitability has been under pressure and falling over the period up to 30 June 2012, reflecting pricing pressure, lower margins and greater volatility in disability income insurance.

The following graph illustrates what has happened. Specialist group insurers are under the most pressure and as insurers have foreshadowed we expect to see rates firming up during the next tender cycle.



Source: APRA Half-Yearly Bulletins, data not available for Group Disability in year ending June 2009 due to masking by APRA to maintain confidentiality.

A world of fewer and larger funds

In 1995 there were more than 5,000 large super funds, most of them corporate. However by 2004 APRA only listed around 670 funds, and eight years later we are down to just over 200 funds.

We expect to see more consolidation this year now that capital gains tax relief has been extended to 2017 and the uncertainty around CGT that caused a slight slowdown in consolidation in FY12 has been clarified.

This together with the introduction of a scale test under Stronger Super, and the prospect of much more stringent oversight of fund operations, will lead to further consolidation in the industry.

	Number of funds			Assets held ($millions)			Membership (millions)		
Year ended 30 June	Industry	Retail	Corporate	Industry	Retail	Corporate	Industry	Retail	Corporate
2012	53	92	52	260,088	356,360	46,513	11.7	9.8	0.5
2011	56	92	71	244,776	361,065	56,569	11.4	10.6	0.6
2010	61	112	85	219,440	321,173	54,481	11.5	10.5	0.6
2009	63	121	103	187,413	298,588	52,753	11.6	10.5	0.7
2008	65	124	125	195,646	329,788	57,360	11.3	10.4	0.7
2007	69	135	143	193,172	356,233	66,115	10.7	10.2	0.7
2006	71	144	169	148,524	287,240	49,620	10	10.1	0.6
2005	77	160	267	115,338	237,868	49,759	9.4	9.9	0.7
2004	75	192	368	88,602	203,196	48,039	8.7	9.9	0.8

Source: APRA and Deloitte Actuaries and Consultants analysis 2013

Market shares are changing

We found that the market share of Industry, Retail, Corporate and Other funds changed over the eight year period by member account numbers and by assets. APRA classifies 'Other' to include Public Sector and Eligible Rollover Funds (ERFs). ERFs are largely built up by super funds unilaterally transferring small, lost and inactive accounts.

At 30 June 2012 there were more than 4.7 million ERF accounts, many of which are very small. The official commentary on the Stronger Super reforms questions the value of these Eligible Rollover Funds and we also ask whether these funds have now passed their use by date?

	Market share by assets %				Market share by membership %			
Year ended 30 June	Industry	Retail	Corporate	Other	Industry	Retail	Corporate	Other
2012	32.7	44.8	5.8	16.7	40.2	33.7	1.7	24.4
2011	31.1	45.9	7.2	15.8	38.4	35.7	2.0	23.9
2010	31.5	46.1	7.8	14.6	37.1	33.9	1.9	27.1
2009	31.0	49.4	8.7	10.8	38.2	34.5	2.3	25.0
2008	29.9	50.4	8.8	10.9	37.9	34.9	2.3	24.8
2007	28.1	51.8	9.6	10.5	37.8	36.0	2.5	23.7
2006	26.8	51.8	8.9	12.5	37.0	37.4	2.2	23.3
2005	25.5	52.5	11.0	11.1	36.9	38.8	2.7	21.6
2004	23.1	53.0	12.5	11.4	35.7	40.6	3.3	20.5

Source: APRA and Deloitte Actuaries and Consultants analysis 2013

Insights from cash flows

In 2012, contributions rebounded to reach their highest level since the global financial crisis, however the caps imposed by government on older Australians contributing up to $25,000 into their superannuation accounts at the concessional tax rate is a concern.

The industry is actively lobbying the federal government to consider the long term view to provide confidence to the millions of Australians facing retirement (whether voluntary or forced) over the next few years.

Non-investment cash flows (all amounts in $millions)

Year ended 30 June	M'ship at end (millions)	Pensioners (millions)	Assets at start	Assets at end	Operating expenses	Group life premium	Conts.	Net roll-ins	Benefits paid
2012	29.1	0.9	760,663	795,724	4,355	4,430	76,309	6,555	39,809
2011	29.7	0.9	678,333	787,094	4,204	3,802	70,397	31,235	35,296
2010	31	0.8	602,457	697,131	3,784	3,325	67,662	13,718	30,987
2009	30.4	0.8	651,494	604,169	3,510	3,037	66,233	3,592	32,661
2008	29.8	0.7	679,150	654,098	3,641	2,483	71,166	6,111	36,065
2007	28.3	0.6	548,194	687,358	3,404	2,088	79,987	14,193	29,966
2006	27	0.5	439,556	554,862	2,928	1,752	54,220	33,179	27,510
2005	25.5	0.4	375,156	453,043	2,507	1,500	45,430	15,834	24,434
2004	24.4	0.4	321,057	383,455	2,306	1,307	41,341	10,964	23,888

Source: APRA and Deloitte Actuaries and Consultants analysis 2013 (These are totals for all APRA reported funds.)

While we applaud the progress made in reducing the number of accounts in super funds, the concessional contribution limit of $25,000 falls short of undertakings given in the past by both major parties and ignores the fact that the overwhelming majority of Australians are retiring with benefits totally inadequate to provide even a moderate lifestyle.

Many Australians facing retirement have not been able to contribute in the past and relied on the ability to 'catch-up' by making additional voluntary contributions in years preceding their retirement.

Operating costs in super are increasing

Operating costs also continued to steadily increase in 2011/2012 and have for the first time reached an annual average of $150 per member – just over 6% more than in 2010/2011.

We believe that operating costs are best analysed as a dollar amount per member, notwithstanding the preference of many to express them as a percentage of the account balance.

The increase in operating costs can sometimes be masked by the increase in average account balances if costs were expressed as a percentage of account balance.

Operating expenses in more detail (all amounts in $millions)

	(millions)		Fees					Operating expenses		Operating costs	
Year End 30 June	M'ship at end	Pensioners	Mgmt	Admin	Actuarial	Trustee, Director	To Audit firm	Other	Total	$pm/pa	% assets
2012	29.1	0.920	1,037	2,361	7	489	19	442	4,355	150	0.56%
2011	29.7	0.890	1,053	2,211	7	454	19	460	4,204	141	0.57%
2010	31.0	0.783	957	1,988	10	407	20	401	3,784	122	0.58%
2009	30.4	0.751	712	1,786	7	391	21	591	3,510	116	0.56%
2008	29.8	0.689	718	1,751	6	423	21	720	3,641	122	0.55%
2007	28.3	0.583	583	1,752	7	400	23	641	3,404	120	0.55%
2006	27.0	0.52	572	1,488	10	361	19	478	2,928	109	0.59%
2005	25.5	0.449	396	1,428	14	273	17	380	2,507	98	0.61%
2004	24.4	0.399	463	1,276	17	210	19	322	2,306	95	0.65%

Source: APRA and Deloitte Actuaries and Consultants analysis 2013

All the increases in operating costs per member that are documented have occurred before the serious work of responding to Stronger Super and other government reforms really gets under way. We believe that operating costs will continue to increase over the next two to three years.

Operating costs per member

	Industry funds	Retail funds	Corporate funds			
Year End 30 June	$ pa	% of assets	$ pa	% of assets	$ pa	% of assets
2012	103	0.48%	268	0.75%	299	0.31%
2011	94	0.48%	248	0.77%	293	0.32%
2010	89	0.51%	218	0.77%	258	0.31%
2009	84	0.51%	208	0.70%	243	0.29%
2008	75	0.43%	235	0.72%	243	0.26%
2007	71	0.44%	228	0.73%	248	0.27%
2006	60	0.47%	197	0.76%	259	0.32%
2005	56	0.52%	170	0.77%	223	0.32%
2004	52	0.57%	158	0.83%	212	0.37%

Source: APRA and Deloitte Actuaries and Consultants analysis 2013

Operating costs

Industry, retail and corporate operating costs vary greatly because of different levels of service offered to members. Some retail and corporate funds provide extensive services and so average fund costs are often higher.

Costs also depend on the complexity of the benefit. It is dangerous to stereotype, as the actual annual costs of individual funds can rise well above $700 per member. Funds classified by APRA as retail, industry as well as corporate, are in this group.

Operating costs in industry funds increased by more than 9% to $103 per annum, and retail funds by more than 8% to $268 per annum. In contrast corporate fund costs held fairly level.

As a Fellow of the Institute of Actuaries of Australia with deep technical knowledge of Australian superannuation, Wayne and his team combine actuarial skills and training in the financing of benefits with the experience gained in managing and guiding significant superannuation businesses. Stephen is a partner in Deloitte's Actuaries & Consultants team with more than 20 years' experience in superannuation, life insurance and funds management.

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The total assets of self-managed superannuation funds will exceed $500 billion by June 2013 thanks to a strong equity market and a continuing interest by individuals in setting up their own self-managed superannuation funds

SMSFs exceed 500,000 funds and are on track for $500b in assets by FY end

Despite the restrictions on concessional contributions, self-managed funds are the superannuation industry's strongest growing sector. Deloitte research has shown that once those with higher superannuation balances approach or reach retirement, the SMSF option becomes more attractive.

The strong increase in the number of Australians with SMSFs now exceeds 500,000 accounts with almost 950,000 members. Based on current growth patterns, membership in this sector is likely to reach one million by the end of the calendar year. The trend is to establish funds in the June quarter as individuals assess their tax positions at the end of the financial year.

As Australians seek tax or financial planning advice to consider more effective savings strategies, more often than not this includes maximising their superannuation position. As SMSF growth is continuing to challenge retail and industry funds to retain member numbers they are beginning to offer direct Australian equity and term deposit options, with more sophisticated offerings on the way.

Admitted as a solicitor in the Supreme Court of NSW in 1981 Russell now leads the Deloitte Superannuation practice advising corporate, government and industry funds on a range of issues including strategy, product development, governance, insurance and compliance. Robert is a partner in our Deloitte private practice specialising in self-managed super funds.

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New internal audit requirements for superannuation funds

Now that APRA requires super funds to have an independent internal audit function, Deloitte Financial Control Assurance & Advisory Directors James Oliver and Vincent Sita look at what that means and how to make the function fit for purpose for your fund

The APRA Prudential Standards ('the Standards') require super funds to have a dedicated internal audit function, and stipulate the minimum scope of internal audit and related assurance activities. The Standards that have specific requirements for internal audits include Business Continuity Management (SPS 232), Outsourcing (SPS 231), Operational Risk Financial Requirements (SPS 114) and Risk Management (SPS 220). Further, there are requirements for independent assessments in the areas of Governance (SPS 510), Investment Governance (SPS 530) and Insurance in Superannuation (SPS 250).

Regardless of whether a trustee is setting up an in-house, co-sourced or fully out-sourced internal audit function, it has a responsibility to ensure that the function is performing in a way that provides the maximum value for its members.

There is no generic internal audit model to apply; it must be designed and maintained to be fit for purpose.

What's the value of internal audit?

The primary responsibility of internal audit is to provide independent oversight over the fund's financial, operational and compliance controls and to assess the effectiveness of the overall risk management framework. In addition a well-functioning internal audit is typically expected to:

- Support trustees by identifying potential issues, emerging risks and helping to find practical solutions
- Benchmark the fund against its peers and better practices
- Act as a trusted sounding board for management and the board
- Assist in maintaining appropriate controls as required under the company licence and the Prudential Standards
- In their scoping, have regard to other assurance activities across the fund to avoid duplication of time and money.

Establishing an internal audit function – some factors for success

Reach a consensus on what internal audit means for your organisation:

- Full and frank discussion between management, the board, audit committee and the actual or proposed internal auditors should enable most differences to be ironed out. Developing and approving an internal audit charter is a good way to force discussion and agreement.

Choose the model:

- Every organisation must decide whether an in-house, co-source or out-source function is best for them and that will often be determined by a variety of factors including cost, flexibility and control, objectivity, capability and talent.

Hire the right people:

- As well as having the required skills, a good auditor should have the ability to form strong relationships and instill confidence across the business, the audit committee and the board. A good auditor should have a persuasive personality and be able to comment on the business and make suggestions.

Set specific reporting lines:

- It is important to define the reporting lines with a view to independence and the ability to influence. The internal auditor must have free and unfettered access to the audit committee.

Coordinate assurance activities:

- Trustees within the organisation need to understand the role and scope of internal and external audit, risk and compliance and other 'assurance' providers. An assurance mapping excercise helps with this process by identifying gaps and duplications in assurance effort.

Build a balanced audit plan

- Which is informed by several input factors including the fund's risks, strategies, objectives and other business initiatives. Any plan still needs to be capable of adapting to emerging risks such as regulatory changes or major projects.

James is a director within Deloitte's financial services assurance group and has 12 years' experience in London and Sydney. He specialises in audits and reviews of internal controls including internal audit, GS 007, risk, compliance and governance reviews, special investigations, along with fund and superannuation audits. Vincent has over nine years' experience in the financial services industry and also specialises in internal audit and control assurance.

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IFRS 9 impairment new exposure draft issued

Deloitte Treasury and Capital Markets Partner Steven Cunico and Director Fridrich Housa consider the implications and differences in the IASB and FASB approaches to the treatment of Financial Instruments Expected Credit Losses

At a glance

- New exposure draft released March 2013
- Divergence in the IASB and the U.S. FASB approach
- Transfer between Bucket One and Bucket Two/Three based on significant deterioration in credit quality and only if credit quality is below investment grade.

Fast facts

Deloitte's 3rd Global IFRS Banking Survey found that:

- Despite significant support for the convergence process, most banks consider that the two boards (IASB and FASB) are no longer on track to achieve it
- Capital and pricing impacts of the changes, including impairment, will be significant
- Constituents are putting their implementation efforts on standby due to delays in the process.

The bottom line

The delayed IASB Financial Instruments Expected Credit Losses exposure draft was issued on 7 March 2013 (Draft ED/2013/3) with comments due by 5 July 2013. It proposes the following with respect to the recognition, measurement, presentation, and disclosure of expected credit losses:

- The IASB model applies to all financial assets subject to measurement of expected credit losses as well as some loan commitments and financial guarantee contracts
- In the case of purchased or originated credit-impaired financial assets and other financial instruments where credit risk has increased significantly since initial recognition, the loss allowance is measured at an amount equal to lifetime expected credit losses
- For all other financial instruments subject to the proposals, the loss allowance is measured at an amount equal to the 12 month expected credit losses
- The estimate of expected credit losses reflects an unbiased and probability-weighted amount (determined by evaluating the range of possible outcomes) as well as the time value of money
- Depending on the status of a financial asset with regard to credit impairment (reflecting criteria similar to IAS 39 guidance), interest revenue is calculated in different ways
- The proposals include extensive disclosure requirements that aim to identify and explain the amounts in the financial statements arising from expected credit losses and the effect of deterioration and improvement in the credit risk of financial instruments subject to the proposals.

The context

This IASB draft follows the FASB's own exposure draft containing the Current Expected Credit Loss (CECL) proposals that were issued in December 2012 and is open to submissions until April 2013. Despite the efforts over a three year period the IASB and FASB were unable to reach an agreed response to the treatment of financial instruments expected credit losses. To that end the FASB CECL model was developed on U.S. banks' feedback that the proposed IASB model was difficult to understand, audit and implement. The banks also felt that the IASB approach would be likely to result in lower allowances for impairment losses on some loan portfolios.

FASB's alternative model proposes a single, rather than a dual-measurement approach for impaired financial assets, and also recognises full lifetime expected credit losses. An entity would recognise an allowance for credit impairment equal to the entity's current estimate of the contractual cash flows that are not expected to be collected on initial recognition of the financial asset and on each subsequent reporting date.

The detail

The IASB Exposure Draft's three-bucket approach – Recognition of Expected Losses

Bucket One

Bucket One would consist of financial assets where there has been no identified credit deterioration since initial recognition. All financial assets, except for purchased credit-impaired assets, would start in this bucket regardless of their level of credit quality. Financial assets in this bucket would have a credit allowance for 12 months 'expected' losses.

This means that the credit allowance will be measured as all cash shortfalls expected over the lifetime of an asset associated with the likelihood of a loss event in the next 12 months. The expected losses would be estimated using an 'expected value' approach (i.e. probability-weighted average approach). However, use of other reasonable methods to approximate expected values, such as probabilities of default (PDs), loss-given defaults (LGDs) and/or exposures at default (EADs) would be permitted with acknowledgement that several statistical approaches may approximate a present value amount.

Transfer

Financial assets would transfer from Bucket One to Bucket Two or Bucket Three when:

- There has been significant deterioration in credit quality since initial recognition considering the term and original credit quality
- The credit quality of the asset would not be considered 'investment grade'.

Note: Change in pricing of an existing financial asset due to increased credit risk would be an example of significant deterioration.

The IASB emphasised that, when applying the transfer criteria, judgement would be required and agreed not to include any 'bright-line' threshold. The Board decided that an entity should use the best information available without undue cost and effort and that a 12-month probability of default (PD) can be used to assess the lifetime expected loss criterion, unless this would contradict a lifetime PD.

Also that delinquency information may be considered to assess the need to recognise lifetime expected losses with presumption (rebuttable) that the criterion is met if an asset is 30 days past due.

Bucket Two/Three

Once transferred from Bucket One, the financial assets in Bucket Two or Three would have an allowance measured as the lifetime expected credit losses for the financial assets. For Bucket Two this is at a portfolio level, while Bucket Three would be at the individual instrument level. Portfolios would transfer from Bucket One to Bucket Two, while individual instruments would transfer from Bucket One or Two, to Bucket Three. When evaluating assets on an aggregated basis, to ensure sufficient granularity, the financial assets should not be aggregated at a higher level if there are shared risk characteristics for a sub-group that would indicate whether recognition of lifetime losses is appropriate as of the assessment date. The grouping may change each period.

Shared risk characteristics may include asset type, credit risk ratings, past-due status, collateral type, date of origination, term to maturity, industry, geographical location of the debtor, the value of collateral relative to commitment for non-recourse assets, which may influence a likelihood of the debtor electing to default and other relevant factors. It is permitted to individually evaluate a financial asset within the group for recognition of lifetime losses as an alternative to a collective assessment.

Indicators such as PDs, pricing, credit ratings, origination rates, general market conditions, performance of the borrower, expected breach of loan covenants and change in the credit risk management approach in relation to the financial asset, are examples of the information available to assist in determining when the lifetime expected losses should be recognised. That is when the financial asset moves from Bucket One to Bucket Two or Three.

The estimate of expected losses will require consideration of all reasonable and supportable information, consideration of a range of possible outcomes including their likelihood and consideration of the time value of money.

Accounting for purchased credit-impaired assets

The IASB tentatively decided that the purchased credit-impaired assets should be initially classified in Buckets Two or Three and would not be permitted to be moved to Bucket One should credit improvements occur after initial recognition. An impairment allowance would be recognised based on the changes in lifetime expected cash flows since acquisition. Both favourable and unfavourable changes in expected cash flows would be recognised immediately in profit and loss in the same line item.

Trade receivables

For trade receivables with a significant financing element the 'simplified approach' would permit a policy election to apply lifetime expected losses at initial recognition and throughout the life of the asset instead of applying the three-bucket model. For trade receivables without a significant financing component, lifetime expected losses would be applied on initial recognition and throughout the life of the asset.

Transition

Entities should use the credit quality at initial recognition for existing financial assets when initially applying the new impairment model unless obtaining such credit quality information requires undue cost or effort. If the credit quality at initial recognition is not used at the date of initial application, the transition provisions would require these financial assets to be evaluated only on the basis of the second criterion in the transfer notion: whether the credit quality is below 'investment grade' at the date of initial application. When assessing the need to recognise lifetime expected losses based on delinquency information, the application of lifetime expected losses at transition will be required if the asset is considered delinquent, otherwise, a 12-month allowance would be required.

What's next?

The IASB exposure draft addresses some of the initial challenges of the three-bucket approach, however a few issues remain including whether entities:

- Have sufficient data to obtain expected losses for 12 months such as LGDs, PDs, EADs
- Can determine an adjustment from a through-the-cycle estimate (used for calculation of reserves for regulatory purposes) to a point-in-time estimate required by accounting standards
- Can practically interpret the term 'significant deterioration in credit quality' and 'investment grade' and the impact of this interpretation on comparability of the financial results of financial institutions
- Can determine when an asset is transferred back to Bucket One from Bucket Two/Three
- Have sufficient future economic forecast data available to calculate lifetime expected losses and so determine the impact on the volatility of the reported results.

Failure to achieve convergence between the IASB and FASB does not help comparability between those entities reporting under U.S. GAAP and IFRS (or its equivalent). The two approaches differ in terms of operational requirements, pro/counter-cyclicality and ultimately credit losses recognised, with the flow-on impact on capital requirements and profitability. It is expected that both boards will re-consider their respective models following the public commentary.

Steven has more than 13 years' experience in Australia and the UK auditing and advising financial institutions and large corporates on financial reporting matters, in particular financial instruments accounting. He is a recognised industry expert advising on the application of IFRS, in particular financial instruments accounting standards including IAS 32, IAS 39, IFRS 7 and IFRS 9, has spoken at numerous conferences and has also written articles for various technical journals. Fridrich is a member of Deloitte's Treasury and Capital Markets practice bringing his financial instruments advisory services expertise to his banking industry clients.

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ASIC update: Regulatory action

Last year, ASIC accepted 18 enforceable undertakings with a further seven in January 2013. Our Governance and Regulatory and Consulting team has identified the focus of ASIC's increased surveillance and enforcement

ASIC's surveillance and enforcement activity is focused on risk-based areas of regulatory reform in the industry and is expected to continue as the regulatory environment evolves.

Trends in surveillance and enforcement activity:

- Administration and enforcement of the *National Consumer Credit Protection Act 2009* (Cth), which has included businesses operating a consumer lease without an Australian Credit Licence and/or meeting the disclosure requirements of that Act
- Australian Financial Services Licensees' (AFSL) risk frameworks and compliance processes, with a particular focus on quality of advice provided by advisors, monitoring and supervision of representatives, disclosure requirements, client file reviews and record-keeping
- Misleading and deceptive conduct in respect of false statements disclosed to retail clients on the operations of a scheme and misappropriation of assets
- Registered liquidators who have failed to carry out their duties as a liquidator or who are otherwise not fit and proper persons to remain registered as liquidators.

ASIC consults on reforms to regulation of the debenture sector

On 13 February 2013, ASIC released a number of proposals to strengthen the regulation of the debenture sector and improve investors' understanding about debenture investments. These proposals aim to improve the financial strength and sustainability of finance companies that issue retail debentures and clearly differentiate debenture issuers from building societies, banks and credit unions that are regulated under APRA's prudential framework.

ASIC's proposals follow a number of high-profile collapses in the debenture sector, including Banksia Securities Ltd, which led to the government's announcement in December 2012 that ASIC would consult on strengthening the regulation of finance companies that issue debentures to retail investors and the subsequent establishment of ASIC's debenture taskforce.

The proposals introduce minimum capital and liquidity requirements for debenture issuers, strengthen ongoing disclosure to investors about issuers, restrict the issuer's ability to offer 'at call' investments, clarify the role of auditors and powers and duties of debenture trustees, among others. These proposals seek to help investors understand the risks of debenture investments compared to deposits that are prudentially supervised by APRA.

FOFA update

ASIC released guidance on code approval under Future of Financial Advice (FOFA) reforms.

ASIC has existing power under the *Corporations Act* to approve, on application, codes of conduct, with *Regulatory Guide 183 Approval of financial services sector codes of conduct (RG 183)* setting out ASIC's minimum expectations in respect of the activities of Australian financial services licensees (AFSLs), their representatives or issuers of financial products.

On 1 March 2013, ASIC released final guidance for approval of codes of conduct under FOFA. The guidance outlines the following areas:

- ASIC's general approach to approving codes and relief process
- ASIC's approach to approving codes in line with the 'opt-in requirement' under s962K of the *Corporations Act 2001*
- How to obtain and retain approval for a code.

The approved FOFA codes are designed to help industry meet the policy objective of the 'opt-in requirement,' which requires an advisor who enters into an ongoing fee arrangement with a retail client after 1 July 2013 to give that client a renewal notice every two years. This requirement is aimed at protecting clients from paying ongoing fees where limited or no financial advice or service is received.

ASIC releases guidance on FOFA fee disclosure statements

Under the FOFA reforms, an advisor who provides personal advice to a retail client with whom they have an ongoing fee arrangement which is for more than 12 months, must provide an annual fee disclosure statement (FDS) to that client. This obligation is designed to assist the client with assessing whether their ongoing fees are proportionate to the services they are entitled to or have received. The FDS must outline the services provided to and/or those entitled to by the client and the fees paid by the client.

On 25 January 2013, ASIC released *Regulatory Guide 245 Fee disclosure statements (RG 245)* to assist AFSL holders and their representatives to meet the FDS requirements when they provide personal advice to retail clients under the FOFA reforms.

RG 245 explains:

- The FDS obligations and when these apply
- Who must provide an FDS
- The circumstances giving rise to the obligation to provide an FDS
- The information required to be disclosed in the FDS.

For the first 12 months of the FOFA reforms (i.e. until July 2014), ASIC will take a facilitative approach to administering the new FDS obligations.

ASIC releases guidance on conflicted remuneration ban

On 4 March 2013, ASIC released *Regulatory Guide 246 Conflicted remuneration (RG 246)* to provide industry guidance in complying with the ban on conflicted remuneration as part of the FOFA reforms. This obligation applies to conflicted remuneration in respect of certain general and/or personal financial product advice (which includes investment platforms, managed investments and superannuation) to retail clients, with bans applicable to volume-based payments and shelf space fees, commissions and soft dollar benefits.

RG 246 is designed to help industry comply with and understand the practical operation of the ban on conflicted remuneration and how ASIC will administer it. The guidance covers:

- Volume-based benefits and shelf space fees
- Asset-based fees on borrowed amounts
- Performance benefits for employees
- The anti-avoidance provision
- Transitional provisions.

The underlying principle of the final guidance and the ban on conflicted remuneration is to improve the quality of advice by more closely aligning the interests of advisors and their retail clients.

ASIC consultation on risk management for responsible entities

On 21 March 2013, ASIC released *Consultation Paper 204 Risk management systems of responsible entities (CP 204)* for industry review and comment. In addition to existing guidance in *Regulatory Guide 104 Licensing: Meeting the general obligations (RG 104)*, ASIC intends to develop good practice guidance on risk management systems for responsible entities by proposing guidance that is based on many current practices that include:

- Ensuring risk management systems processes adequately identify, assess and treat risks
- Ensuring these processes are suitable for individual business objectives and operations
- Ensuring that risk management systems address all material risks within individual businesses
- Reviewing risk management systems regularly – and not less than annually – for appropriateness, effectiveness and relevance to individual businesses.

CP 204 addresses the findings released in Report 298 Adequacy of risk management systems of responsible entities (REP 298). Submissions in response to CP 204 are due by 3 May 2013.

ASIC credit reform update

New credit obligations effective from 1 March 2013

The *National Consumer Credit Protection Amendment (Enhancements) Act 2012 (Enhancements Act)* introduces a range of key reforms and new credit obligations effective from 1 March 2013. These key reforms include:

- Procedural changes for applications of hardship under the National Credit Code
- Consumer protections for reverse mortgages
- New disclosure requirements in relation to consumer leases and employer payment authorisations
- Remedies for dishonest and unfair conduct by credit service providers
- New obligations for 'small amount' credit contracts and a ban on short-term credit contracts.

ASIC will work with industry participants to administer these new requirements and address any problems.

Credit advertising

ASIC will continue to regularly review advertising on credit products and services following the release of its updated guidance in November 2012 as part of *Regulatory Guide 234 Advertising financial products and services (including credit): Good practice guidance*. The guidance includes new information relating to restricted terminology and comparison fees, rates and costs, to help industry participants avoid engaging in or making misleading or deceptive conduct and statements.

ASIC releases guidance on responsible lending to include new laws

On 25 February 2013, ASIC released revised guidance to include new responsible lending provisions in line with the *Consumer Credit Legislation Amendment (Enhancements) Act 2012 (Enhancements Act)*. This guidance takes the form of an updated *Regulatory Guide 209 Credit Licensing: Responsible lending conduct (RG 209)*. The underlying principle of this guidance is that credit licensees must not enter, suggest or assist a consumer in a credit contract or consumer lease if it is unsuitable for the consumer.

The revised RG 209 now includes guidance on the following:

- Lenders of small amount credit contracts – on the minimum requirements when determining what inquiries and verifications are reasonable, and includes obtaining and considering account statements as a minimum requirement to verify the consumer's financial situation
- Lenders of small amount credit contracts – when undertaking a credit assessment and considering the presumption of substantial hardship and protected earning amount requirements
- Lenders offering reverse mortgages – on their responsible lending obligations, which include obtaining consumer projections that relate to the value of the property that will be subjected to a reverse mortgage, and the consumer's indebtedness over time if entering into a reverse mortgage contract

- Responsible lending obligations of the lessor when undertaking a 'final assessment' to ensure the consumer lease is not unsuitable for the consumer
- A new obligation for lessors and credit providers to assess whether a consumer lease or credit contract is unsuitable for a consumer before making an unconditional representation to the consumer that the credit limit will be able to increase for an existing credit contract, or whether the consumer is eligible to enter into a consumer lease or credit contract with the licensee.

ASIC guidance on Stronger Super implementation

On 25 February 2013, ASIC released guidance on the disclosure requirements of the Stronger Super reforms. This guidance takes the form of a concise Frequently Asked Questions (FAQ) document on MySuper transitional disclosure, product dashboards and portfolio holdings with information sheets due to be released around 1 July 2013. Information sheets are expected from ASIC on the requirements to align disclosure with APRA data collection requirements and intra-fund advice.

During the 12 months following from the Stronger Super reform from 1 July 2013, ASIC will take a facilitative and measured approach, particularly regarding trustees being required to meet IT systems and compliance requirements.

Vivienne is the Melbourne leader of the Deloitte FSI Governance & Regulatory Consulting team with the Assurance and Advisory practice. She has more than 10 years' experience providing assurance and advisory services to the financial services industry.

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APRA releases response to conglomerate group supervision

APRA proposes to extend standards for 'governance', 'fit and proper', 'outsourcing' and 'business continuity management' that currently apply to stand-alone entities (Level 1 supervision) and single industry groups (Level 2 supervision) to conglomerate groups (Level 3). The responsibility for compliance will be on the Level 3 Head.

Changes will also be proposed to the four cross-industry behavioural standards to align with recently released behavioural standards for superannuation. This change will affect all ADIs, general insurers and life insurers on a Level 1 basis, and all Level 2 and Level 3 groups.

Group governance requirements

- *Governance (CPS 510):*
  - The board of the Level 3 Head is responsible for ensuring directors and senior management have the skills required for effective and prudent management of the group
  - The Level 3 Head must establish and maintain a documented remuneration policy
  - The Level 3 Head board audit committee must provide an objective review of the group's financial reporting and risk frameworks
  - Employees are not constrained from providing information to APRA
- *Fit and Proper (CPS 520):*
  - Material Level 3 domestic and international activities must take into consideration the impact on the group's financial and operating health
- *Outsourcing (CPS 231):*
  - Level 3 Head must maintain a group-wide outsourcing policy
- *Business Continuity Management (CPS 232):*
  - Level 3 Head must maintain a group-wide business continuity policy
- *Audit and Related matters (3PS 310):*
  - A Level 3 Head must appoint a group auditor who is fully informed of the requirements applicable to the Level 3 Head
  - The appointed auditor must provide assurance on APRA data collections applicable to the Level 3 Head
  - The appointed auditor must provide assurance that Level 3 Head has controls to ensure compliance to prudential requirements.

Risk exposure requirements

- *Aggregate risk exposures (3PS 221)*
  - The board of directors of the Level 3 Head must ensure that adequate systems and controls are in place to identify and manage aggregate risk exposures across the Level 3 group
  - The Level 3 Head must implement a group-wide aggregate risk exposures policy which articulates limits across parameters such as counterparties, industry sectors and geographical locations
  - Existing exposure limits at Level 1 and 2 apply
  - The Level 3 Head must report to APRA any aggregate risk exposures
- *Intra-group transactions and exposures (ITEs) (3PS 222)*
  - The Level 3 Head must ensure adequate systems and controls are in place to identify and manage ITEs
  - The Level 3 Head must implement ITE systems and policies to manage ITEs across the group
  - Existing exposure limits at Level 1 and 2 apply
  - The Level 3 Head must report to APRA on ITEs.

For both of these prudential requirements, APRA may also impose limits or adjustments to the Level 3 group if it believes the group is exposed to significant or excessive risks/ ITEs.

This first consultation pack releases four new standards which apply to the Level 3 Head and Level 3 groups, as well as amendments to standards.

New Standards:

- Prudential Standard 3PS 001 Definitions (3PS 001)
- Prudential Standard 3PS 221 Aggregate Risk Exposures (3PS 221)
- Prudential Standard 3PS 222 Intra-group Transactions and Exposures (3PS 222)
- Prudential Standard 3PS 310 Audit and Related Matters (3PS 310).

Amended existing standards:

- Prudential Standard CPS 231 Outsourcing (CPS 231)
- Prudential Standard CPS 232 Business Continuity Management (CPS 232)
- Prudential Standard CPS 510 Governance (CPS 510)
- Prudential Standard CPS 520 Fit and Proper (CPS 520).

Standards to be released for consultation in the first half of 2013:

- Prudential Standard 3PS 110 Capital Adequacy (3PS 110)
- Prudential Standard 3PS 111 Capital Adequacy: Measurement of Capital (3PS 111)
- Prudential Standard CPS 220 Risk Management (CPS 220).

Consultation on the proposed governance and risk exposure prudential standards closed on 1 March 2013.

Consultation closes for PPG 235 managing data risk

On 11 December 2012, APRA released its draft Prudential Practice Guide *(PPG 235 Managing Data Risk)* for managing data risk, providing guidance on data risk management in light of weaknesses identified as part of APRA's ongoing supervision activities.

The PPG has been directed at multiple audiences, reflecting the fact that managing data is not just a technical issue. The guide aims to provide direction to senior management, as well as to risk management, business and technical specialists.

The standards provide guidance in regard to:

- Data risk encompassing the risk of loss and assessment of data quality
- Outlining an approach for the framework, roles and responsibilities and monitoring of ongoing compliance effectiveness
- Staff training and education programs
- Considering data quality at each stage of its lifecycle and the appropriateness of controls
- Control considerations for business continuity, outsourcing and 'auditability' of data
- Assessing validity and origination of data and its sources
- Monitoring and managing detection of data-quality problems
- Data-quality assurance programs and the frequency of testing programs.

APRA releases discussion paper outlining changes to statistical publications

General insurance

The changes proposed by APRA will aim to increase the range of statistics provided to users as well as improve its timeliness and usability for industry analysis.

To allow for this, APRA proposes to change its view on data submitted by general insurers under the *Financial Services Collection of Data (FSCOD) Act* and will deem all data submitted to APRA as non-confidential. This will allow the publication of data from Level 2 general insurance groups and other detailed institution-level data.

APRA is also proposing changes to general insurance statistical publications. These include changes to the institution level publication which will:

- Incorporate 51 statistics on financial performance, financial position and capital adequacy of insurance groups
- Include 28 additional statistics on premiums, risk numbers, investments, recoverable and risk changes for individual insurers.

Changes at the quarterly publication:

- 23 additional statistics relating to premiums, claims, expenses, risks, claim liabilities, recoveries and risk charges
- Inclusion of regulated insurer statistics to the quarterly publication from September 2013.

In light of the above changes, APRA will cease the publication of the General Insurance Supplementary Statistic Tables.

These proposed changes only cover data collected under reporting standards made under section 13 of the FSCOD Act. To this effect, this will only apply to future data submitted to APRA. Data provided to APRA outside the FSCOD Act will not be published.

Similar changes will also affect life insurance statistical publications

Like the changes applying to general insurance publications, data submitted by life insurers and friendly societies under the FSCOD Act will be deemed non confidential.

The changes proposed aim to encourage transparency and accountability of the financial institutions APRA regulates, as well as to promote an understanding of the industry.

A number of changes have been proposed by APRA to allow for a greater analysis of the industry:

- An additional life insurance statistical database containing detailed metadata will be published by APRA, bringing Australia in line with international standards for disclosure
- Additional data relating to gross insurance policy revenue and expenses are to be included in its quarterly life publication and annual friendly society bulletin
- Introduction of the Life Insurance Institution Level Statistics publication containing insurer-level data sourced from annual audited returns of life insurers – this will be published twice a year in June and December
- As a result of these additional statistical publications, APRA will cease publication of the Half Yearly Life Insurance Bulletin.

Responses to the changes to general insurance and life insurance statistical publications closed on 5 April 2013.

Consultation has already closed for the proposed bank, credit union and building society (CUBS) statistical publication changes

Consultation regarding the proposed changes closed on 15 February 2013. Similar to the slated changes to general insurance and life statistics, APRA has proposed to make it easier to analyse banking statistics by changing the type and frequency of data publication.

APRA currently publishes a number of statistical publications: the *Quarterly Bank Performance Statistics; the Quarterly Credit Union and Building Society Performance Statistics*; the *Monthly Banking Statistics*; the *ADI Points of Presence*; and, previously, the *Insight* publication (which ended in April 2012).

To harmonise the data that was published, APRA proposed three changes for consultation:

- Consolidation of the quarterly bank and CUBS performance statistics, into one quarterly ADI performance statistics, allowing the publication of data from all banks, building societies and credit unions in one medium. This publication will incorporate data previously published in Insight, but, unlike previously, data will now be published in aggregate dollar amounts and ratios
- Publication of aggregate statistics from mutual ADIs in the quarterly ADI performance statistics, where APRA will apply its confidentiality protection to ensure that individual mutual's data is not disclosed (unless it has been determined non-confidential)
- Introduction of a publication on quarterly ADI property exposure statistics, providing data on residential property exposures, new housing loan approvals for both owner-occupied and investment loans broken down by loan type.

APRA released the first edition of the *Quarterly ADI Performance Statistics* for the March 2013 reference period and the quarterly ADI property exposure statistics are due for release in the June 2013 reference period.

APRA releases final reporting requirements for superannuation

On 28 March 2013, APRA released a package of 35 final reporting standards, reporting forms and instructions for the superannuation industry. These new reporting requirements represent the first changes to the existing superannuation reporting requirements since their introduction in 2004.

The package is the result of a six-month consultation with industry stakeholders since APRA released its initial discussion paper, *Reporting Standards for Superannuation*, and 31 draft reporting forms on reporting requirements in September 2012.

APRA is implementing the new reporting requirements in two phases. The requirements in 24 of the final reporting standards, relating to MySuper products, prudential requirements and RSE-level financial information, will take effect from 1 July 2013. The remaining 11 of the final reporting standards, relating to defined benefit sub-plan, select investment option and detailed investment reporting, will take effect from 1 July 2014.

Under the new reporting requirements, the RSE licensee is required to submit 10 of the 35 reporting forms on a quarterly basis, while 24 of the 35 reporting forms are required to be submitted annually. The remaining reporting form pertaining to the wind-up of a superannuation fund is to be submitted only when the event has transpired.

The due date for submission by the RSE licensee has also been revised under the new reporting requirements. The quarterly reporting forms will have the due date of 28 calendar days after the end of the quarter for the first quarter ending after 1 July 2013, while the annual reporting forms will continue to be lodged four months after the end of the financial year until 1 July 2015. From 1 July 2015 onwards, the due date for submission of the annual reporting forms is shortened from four to three months after the end of the financial year.

The audit scope in the new reporting requirements will increase substantially. There are currently four reporting forms which require an audit to be performed under the existing arrangement. However, under the new reporting requirements, there will be 18 reporting forms which will require an audit with varying levels of assurance (i.e. either at reasonable assurance or limited assurance).

Frances is one of Deloitte's most experienced superannuation audit practitioners and is the audit partner for a number of the firm's major superannuation clients. Frances has sixteen years' experience in auditing, both in Australia and in the United Kingdom. Additionally Frances also undertakes numerous advisory engagements for clients in the financial services sector.

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