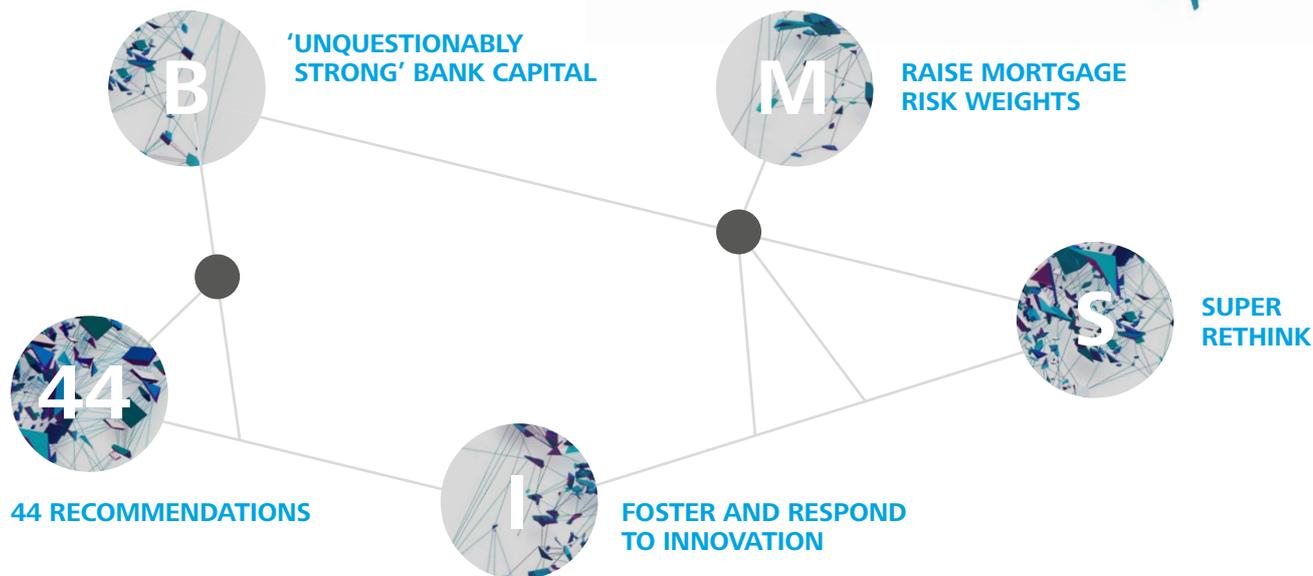


Shaping the future Financial System Inquiry



The Financial System Inquiry has put 44 recommendations in its Final Report to Government, offering what it describes as an 'efficient, resilient and fair' blueprint for the Australian financial system for the next decade and beyond.

The process hasn't ended. The audience has changed, the debate is now more focussed, and industry input is critical.

Deloitte view

Outcomes-based...

The Report takes an outcomes-based approach, avoiding overly prescriptive statements. This is the right approach.

In laying out the objectives the Report effectively calls for further research, analysis, and stakeholder input before detailed policies are finalised. Further, it gives greater flexibility to adjust any resulting policy in a pragmatic way to meet the objectives and future-proof the recommendations.

...the Debate shifts...

The Treasurer has called for submissions by 31 March, 2015. Given the nature of the recommendations this will be a critical period for institutions to ensure subsequent policy reflects the needs of all stakeholders, and builds a stable financial system while promoting growth, innovation and choice.

Importantly a number of reforms, particularly for banks, are linked to the continuing evolution of the G20 regulatory agenda. It is critical that institutions actively engage in this global policy development as the results will impact outcomes in Australia.

... Industry change continues

Although the outcomes-based approach is the right one, it does mean that the regulatory implementation agenda will continue well beyond 2015. Now more than ever, for individual institutions, optimising the productivity of the regulatory spend is critical.

An underlying theme throughout the Report is to establish and maintain the right culture. This is something that all institutions can, and should, attend to now.



RESILIENCE AND COMPETITION

The two headline recommendations are:

1. 'Unquestionably Strong' Bank Capital Levels

Set capital standards such that all ADI capital ratios are in the top quartile globally of internationally active banks.

2. Raise Mortgage Risk-weights

Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for ADIs using IRB risk-weight models and those using standardised risk weights.

In both cases no prescriptive requirements are recommended, rather it is left for further research and consideration by APRA. Requirements for bail-in debt are to accord with global standards, and importantly APRA should work to develop a reporting framework for capital level comparison purposes with international banks. The Report also recognises that the entire Basel framework regarding standardised versus internal models is being reviewed. This international work will inform final outcomes on the mortgage front.

Deloitte view

The next steps are clear for all Australian banks over the course of the next 12 months:

- **Engage Domestically:** *Prepare submissions by the 31 March deadline*
 - The onus is on the industry to prove their theses, whether in relation to international comparisons or competition
 - The report calls for evidence-based policy making - Australian banks need to demonstrate they are well-capitalised relative to their peers
 - This comparison must be robust – one cannot simply compare headline capital ratios
 - On the competition front demonstrate conclusively the true nature and scale of any disparity.
- **Engage Internationally:** *The Basel Committee is conducting a thorough review of the relationship between internal models and standardised approaches through to November 2015*
 - The Basel review will inform the outcomes in Australia on mortgage risk weights, and across all banking businesses. Australian banks should actively engage in this international work
 - *The Financial Stability Board is overseeing global work on establishing Total Loss-Absorbing Capacity (TLAC) requirements to end "too-big-to-fail" determining rules for the 30 most systemically important global banks*
 - The Report recommends these international standards be applied to domestically systemically important banks, so there is an imperative for Australian banks to engage in that global work now.



INNOVATION

The FSI report recommends:

- **Collaboration:** Establishing an 'Innovation Collaboration' – a public-private sector forum to identify trends, foster innovation and ensure forward looking regulation.
- **Digital identity:** Developing a national strategy for a federated-style model of trusted digital identities
- **Data access and use:** Reviewing the costs and benefits of increasing access to and improving the use of data, taking into account appropriate privacy protections.

Deloitte view

Digital disruption is the new currency in financial services. The market is fragmenting and parts of the banking value chain are being disintermediated. This is largely due to the increasing speed of the fintech sector to innovate and launch new products and platforms, with additional momentum being provided through the increasing burden on the regulated sector.

The opportunity is now here to integrate disruptors into the broader financial services ecosystem and retain and develop their new ideas. We welcome the Inquiry's proposal to reframe regulation from limiting, constraining and acting as a barrier to innovation,

to supporting a collaborative forum that operates as an ecosystem of connections, networks and education across the industry.

Working with the customer and through the intelligent and transparent use of data and digital channels, the industry will be able to better understand and engage its customers and build new and innovative pathways, products and ecosystems.

Submissions should focus on ways to optimise the Innovation Collaboration so it isn't just another committee.



SUPERANNUATION

The Report considers the future of superannuation and the issues of post-retirement product and benefit options as well as member choice of funds. It recommends for the first time that the objectives of the system be enshrined in legislation. Whether the Stronger Super reforms have been effective in significantly improving competition and efficiency should be subject to a review by the Productivity Commission by 2020, recommending only after that review that reforms be considered.

The Report proposes that the Commission start designing the principles of the review and the competitive process for default funds in 2015.

It is determined that greater steps are required to ensure there are suitable post-retirement investment options, removing any impediments to product development where appropriate. Importantly the Report recommends maintaining the existing level of choice in the system.

Deloitte view

Deloitte supports these recommendations as we believe that they are intended to provide more competition, and greater security and adequacy in retirement.

The proposed policy measures mean:

- Greater use of life-time and deferred annuities to fund retirement in a more sustainable way and alleviate pressure on the aged pension
- More product choice available to retirees
- Greater innovation and product development to provide complying solutions for retirees.

These recommendations require further policy development to determine:

- How the process will work for new employees
- What the requirements should be for CIPR products

- The impediments, tax or otherwise, to developing a greater suite of CIPR solutions
- Incorporating the level of service and choice in the Australian system into the debate on level of fees
- The defined set of objectives against which policy measures can be assessed.

Institutions must incorporate the level of service and choice in the Australian system into the debate on fees.

The issues of clearly defined objectives and forward policy stability are critical to ensure confidence in the system and encourage voluntary contributions. There must be a strong sense that policy stability will be the norm once the current recommendation process runs its course.



CONSUMERS

To ensure fair treatment the Report states that financial products and services should perform the way that consumers either expect or are led to believe. It calls out current shortcomings in disclosure, quality of advice and the need for both self-regulatory and regulatory changes to strengthen financial institutions' accountability. The Report recommends ASIC has proactive product intervention powers, the introduction of a targeted product design and distribution obligation, substantially increasing the maximum civil and criminal penalties for contravening ASIC legislation to be a credible deterrent for large firms.

Deloitte view Confidence in the financial system is critical. Unless consumers feel fairly treated this won't happen. The GFC undermined both trust and confidence and it is critical that efforts to rebuild both conduct and culture continue. The Report views this very seriously and is recommending far greater powers to ASIC with a strong focus on products stability and governance in line with international trends. **Institutions should continue to proactively progress and improve their culture, selling and product governance practices.**



OTHER CONSIDERATIONS

Two further recommendations of note are the creation of a new Financial Regulator Assessment Board (FRAB) to assess how regulators have implemented their mandates, and for credit cards improving regulation for interchange fees by clarifying thresholds as well as improving surcharging in particular for lower cost payments.

Deloitte view The proposed FRAB will be an important change to the Australian regulatory landscape, with such an oversight body bringing a new lens of accountability to the activities of regulators. The Report identifies real issues with regards to the proposals to improve interchange fee regulation and surcharging regulations. **Of critical importance will be how these difficult issues are implemented.**

WHAT HAPPENS NOW?

The focus now shifts from the Financial System Inquiry to the Government and the regulators. Submissions are due by 31 March 2015. The Report will trigger further intensive public debate, with the final government view expected

by mid-2015 at the earliest. Even then a number of the more significant reforms will require the finalisation of global standards, which are not scheduled until end-2015.

Deloitte view

The outcomes-based approach, with further targeted consultation and analysis before determining final policies is the right approach. It is now imperative that all stakeholders actively engage in the policy debate as these reforms will have far-reaching impacts. This engagement should be at both the domestic and, where appropriate, the international level.

Unfortunately this will mean that regulatory uncertainty will continue throughout 2015, and the consequent implementation burdens will continue through 2016 and beyond. For individual institutions it is critical to optimise productivity and the regulatory spend using a forward-looking flexible framework.

In this alert we have undertaken a high level analysis on what we see as the headline recommendations from the Financial System Inquiry Final Report. Our Deloitte specialists look forward talking through these recommendations with you to determine your organisation's best course of action.

We look forward to sharing our point of view on:

- implications for business strategy and capital allocation
- optimisation of regulatory implementation spend
- product and distribution governance
- the importance of culture and how to effect change.

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